No. 4685.

IN THE

United States

Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

Maryland Casualty Company, a Corporation,

Plaintiff in Error,

vs.

The Citizens National Bank of Los Angeles, a Banking Corporation,

Defendant in Error.

BRIEF OF PLAINTIFF IN ERROR.

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BRIEF OF PLAINTIFF IN ERROR.

History and Nature of the Case.

This action was filed by The Citizens National Bank of Los Angeles (hereinafter referred to as plaintiff bank) as assignee of California Cotton & Factorage Company, a corporation, (hereinafter referred to as cotton company) against the Maryland Casualty Company, a corporation (hereinafter referred to as bonding company) in the Superior Court of the state of California, and thereafter removed to the United States District Court. It was first tried before Judge

Oscar A. Trippet, whose death occurred before decision was rendered; thereafter it was again tried before Judge Wm. P. James, who rendered judgment for plaintiff bank, and the defendant, bonding company, sued out writ of error to this court.

The California Cotton & Factorage Company, plaintiff's assignor, is a California corporation organized in September, 1919, for the purpose of buying and selling cotton on the market. Its authorized capital stock is $100,000.00, divided into 1000 shares of the par value of $100.00 each. The subscribed total capital of $50,000.00 was paid in by T. J. West of Calexico [page 336] and there was issued to him 496 shares of the par value of $49,600.00 [page 149.] The four remaining shares were issued to J. B. Sears, C. H. Hartke, Thomas W. McDevitt, and J. P. Conduit. They paid no consideration for the shares of stock so issued to them, same being issued solely to qualify them as directors [page 336]. McDevitt was elected president; C. H. Hartke, vice-president; T. J. West, treasurer; and J. B. Sears, secretary; and they, together with the said Conduit, constituted the officers and directors of the corporation during all the period of time in issue, except that Hartke acted as secretary for the period beginning May 20th, 1920, and ending Sept. 9, 1920. J. B. Sears, as secretary, was the general manager of the cotton company, and for all general purposes had complete charge of the cotton company's affairs from the date of its organization.

About December 1st, 1919, J. B. Sears applied to the bonding company for a fidelity bond in the penal

sum of $50,000.00 in favor of the cotton company, and such bond was issued by the bonding company on December 19, 1919 [bond set forth on page 17]. Sears died on May 3, 1921, and shortly thereafter the cotton company alleges that it ascertained for the first time that by reason of certain acts of Sears while acting as its secretary the company sustained a loss in excess of the penalty of the bond. The cotton company filed proof of loss with the bonding company on July 22nd, 1921. Thereafter on September 1st, 1921, the cotton company assigned its alleged cause of action on the bond to the plaintiff bank. Plaintiff filed suit thereon on May 11, 1922.

NATURE OF ISSUES.

(A) Complaint.

Plaintiff bank in its complaint sets forth two causes of action. The first charges in brief that by reason of the misapplication by J. B. Sears, as secretary of the cotton company, not to his own use but to the use of the cotton company, of 1091 warehouse or cotton compress receipts entrusted to the cotton company by plaintiff bank, the warehouse receipts were lost to the plaintiff bank and that the cotton company, being responsible (liable) therefor to the bank, a loss to the extent of such liability was sustained for which loss it is claimed the bonding company is liable.

The second cause of action charges misapplication by Sears to his own use of funds of the cotton company. Judgment was for defendant on this cause of action and the matter therein contained is not at issue on this review.

Defendant demurred to the first cause of action as originally pleaded, which demurrer was sustained [page 39.] Thereupon an amendment was filed and a general and specific demurrer was filed to the cause of action as amended [page 33], which demurrer was overruled, and the overruling of said demurrer is one of the assignments of error presented on review.

(B) Answer.

Defendant filed several defenses to the first cause of action. The first defense is a specific denial [page 60].

The second defense pleads that the cotton company breached certain of the promissory warranties, in consideration of which the bond sued upon was issued [page 74], and particularly the warranty that the books and accounts of the cotton company would be checked and audited regularly each month by T. J. West, treasurer. Defendant alleges that the failure of the cotton company to have its books checked and audited as agreed was the cause of any loss sustained.

The third defense [page 78] pleads failure of the cotton company to notify defendant bonding company of the alleged loss within the time expressly provided in the bond.

The fourth defense [page 79] pleads in substance that the cotton company was from the date of its incorporation until May 24, 1920, a corporation sole—to-wit, T. J. West, by reason of the fact that said West was the owner of all the issued stock of the corporation, and that on May 24, 1920 (being a date

prior to the doing by J. B. Sears of any of the acts upon which the alleged loss is based), West sold and transferred to Sears all of said corporate stock, and that thereafter and during all the times when it is alleged the cotton company sustained losses by reason of the acts of Sears the cotton company was in fact a corporation sole—to-wit, J. B. Sears, and by reason thereof all liability on *the bond* insuring Sears' fidelity to the cotton company was extinguished.

The fifth defense pleads in substance that the transactions between plaintiff bank and the cotton company, whereby certain securities, to-wit: cotton tickets were surrendered by the bank to the cotton company, was without fraud or misrepresentation, and that the manner of sale and disposition of the proceeds of the cotton covered by the tickets was known to and approved of by the plaintiff bank, and that the cotton company or plaintiff bank sustained no loss by reason of any fraud or dishonesty or willful misapplication of the bank's property by J. B. Sears.

Statement of Case.

Immediately after the cotton company was organized it arranged with plaintiff bank for a line of credit to the extent of $200,000.00, and arranged to have the plaintiff bank loan to it the money with which to purchase cotton, such money to be repaid from the sale of the cotton. This arrangement between the cotton company and the bank was made by Sears, secretary of the cotton company, and confirmed by a letter to plaintiff bank dated September 8, 1919 [page 212],

a portion of which letter succinctly states the way in which the matter should be handled as agreed upon, to-wit:

"The purpose of the Corporation is the buying, selling and the handling of cotton in bale form in all its different branches, or in other words to do a general legitimate cotton business, which will at all times be on a regular basis and as far from speculation as possible.

"The financing of the cotton bought or sold will at all times be protected by collateral either in the form of Warehouse Receipts or Railroad Bills of Lading, which will be held by the Bank as security together with actual daily balances. These Warehouse Receipts or Bills of Lading will at times have to be replaced with Trust Receipts, in order to facilitate the movement of the cotton, for example in making shipments from the different interior points, it is necessary to have the Warehouse Receipts in order to secure the cotton and get Bills of Lading for shipments and at such times Trust Receipts will be issued by ourselves until we can secure the Outbound Bills of Lading, after which time Bills of Lading attached to Sight Drafts are returned to the Bank and the Trust Receipts taken up.

"All purchases or sales will at all times be protected, either by Actual Sales or Purchases or Hedged in the New York or New Orleans Future market.

"The manner of payment for actual cotton bought will be in the form of Acceptances protected by Warehouse Receipts or Bills of Lading covering the actual number of bales of cotton bought or sold, which will also be covered by Insurance in the form of a Blanket Policy for the amount of $100,000.00.

"It is the purpose of the Company at all times to carry sufficient daily balance to protect its trades, as well as security with collateral attached.

"The total amount of the Acceptance account will vary according to the promptness in making shipments and we do not at any time expect to carry a stock of more than three to five hundred bales and this stock will be covered by actual sales or hedges.

"The Acceptance Account will in some instances run as high as $150,000.00 to $200,000.00, but as an average this will probably be between $50,000.00 to $75,000.00, which will be protected by either Warehouse Receipts or Bills of Lading."

This letter was received by the plaintiff bank on or about the 8th day of September, 1919 [page 215]. Trust receipts were printed in form as set forth on page 25 of the record herein. Thereupon, the cotton company began the purchase of cotton from the various cotton growing sections, purchases being made through its agents in the field. The cotton so purchased was paid for by drafts drawn upon the cotton company through plaintiff bank with compress or warehouse tickets attached covering the cotton so purchased. When these drafts so drawn on the cotton company arrived at Los Angeles, they were accepted by the cotton company through J. B. Sears, secretary and general manager (a few being accepted by other employees), and the drafts so accepted were then paid by the plaintiff bank for the account of the cotton company, and thereupon the drafts so accepted were held by the plaintiff bank in its collection department as bills receivable due from the cotton company.

Thereafter and from time to time as business required, the cotton company secured delivery to itself from the plaintiff bank of the cotton tickets or warehouse receipts which the bank held as security for the payment of the drafts, and the cotton company substituted in lieu of said cotton tickets so delivered to it, a trust receipt. The delivery of the cotton tickets to the cotton company was, as expressly set forth in the trust receipt, for the purpose of securing "delivery of the shipments and secure outbound documents therefor." In other words, the cotton company, in order to sell the cotton so purchased, required delivery to itself of the cotton tickets to the end that the cotton purchased might be graded and allotted for sale. It appears from the testimony [page 407] that in the practical operation of buying and selling cotton it was necessary that the warehouse tickets covering various purchases should be gathered together in order that the cotton so purchased might be classed as to grade and quality before sale was made thereof. This plan of securing a delivery of the warehouse receipts or compress tickets covering cotton purchased and the substitution of trust receipts appears to be in accordance with the general mode of handling the cotton business. [See testimony of Mr. Norsworthy, page 421, and Mr. West, page 341.]

This plan of securing delivery to itself of the cotton tickets held by the bank, and the substitution of trust receipts therefor, was in accordance with the plan approved by the cotton company and by the bank [See letter Sept. 8, 1919, page 212, and testi-

mony of L. C. Ivy, page 215], and was known to and approved of by McDevitt, president of the cotton company [page 273], and by T. J. West, treasurer [pages 341-344]; and was the method in customary use in the buying and selling of cotton.

Thereafter and from time to time, in the conduct of its general business the cotton company sold the cotton covered by the warehouse receipts received from the bank and thereupon it would surrender the warehouse receipts to a railway company and receive bill of lading covering the cotton represented by the surrendered warehouse receipts. The cotton company would then attach the bill of lading to a draft covering the sale price of the cotton, which draft, together with the bill of lading attached, was then deposited by the cotton company to its credit as a cash item in its general checking account at the plaintiff bank. Before depositing the outbound draft with bill of lading attached as a cash item, that is, an item for which the cotton company would receive immediate credit from plaintiff bank, the cotton company would secure the written approval on said draft by some one of the vice-presidents of plaintiff bank. From time to time the cotton company, when moneys were available in its general checking account, would draw checks in favor of the plaintiff bank covering one or more of the acceptances held by the bank as bills receivable due from the cotton company, and would secure a surrender of the acceptance, together with the trust receipt attached thereto. The foregoing is the general plan of operation as carried on between the cotton

company and the plaintiff bank during the whole period of its operations, to-wit, from September, 1919, to May of 1921.

The cotton business is divided into seasons and it is not disputed that the first season of the cotton company's business began in the fall of 1919 and ended in May of 1920, and the second season began in November of 1920 and continued on through to the time of Sears' death in May, 1921. During the first season the cotton company purchased cotton in excess of ninety-five dollars, and drafts aggregating 76 in number covering the purchase price thereof were drawn upon the cotton company through the plaintiff bank, to which drafts were attached the warehouse tickets representing the cotton purchased and all said drafts after being accepted by the cotton company were paid by plaintiff bank. It is not disputed that during the first season all of the warehouse receipts attached to the 76 drafts were withdrawn by the cotton company and trust receipts substituted [page 372]. It is also not disputed that all of the cotton for which trust receipts were issued to plaintiff bank during the first season was sold and the "outbound documents," that is, the drafts with bills of lading attached covering cotton sold, was deposited as a cash item in the checking account of the cotton company in plaintiff bank, and that from time to time and at irregular intervals the cotton company drew checks upon its checking account in favor of plaintiff bank in payment of the acceptances held by the plaintiff bank, and that in no single instance

were the "outbound documents" ever deposited or returned to the collection department of plaintiff bank, and at no time was any of the acceptances or trust receipts held by the plaintiff bank, paid and discharged by the surrender direct to the collection department of plaintiff bank of the "outbound documents," but instead during the whole period of the company's operations all acceptances with trust receipts attached thereto that were paid, aggregating in all in excess of one million dollars, were paid by checks drawn by the cotton company on its general checking account in plaintiff's bank. This plan of handling payments of acceptances and securing redelivery of trust receipts by the sale of the cotton and the drawing of checks on the general checking account was known to and approved of by both the plaintiff bank and the other officers of the cotton company. [See stipulation, p. 352, and testimony of Mr. McDevitt, p. 275, and of Mr. West, p. 343.] During the first year the cotton market was a rising one, the price increasing gradually from 14¢ per pound in the fall of 1919, to as high as 40¢ per pound in the spring of 1920. During the first year the cotton company, on the purchase and sale of cotton made a very substantial profit and was able to take care of all operating expenses and pay for all cotton purchased by it through the plaintiff bank. Consequently no difficulties arose.

The second season of the cotton company's operations began in November, 1920, at which time the cotton market was on the decline, and between that date and May of 1921, when the cotton company ceased

operations, cotton gradually decreased in price from the maximum of 40¢ per pound, to as low as 8¢ per pound [page 342]. An audit of the cotton company's purchase and sales account during the second season shows that on the average every bale of cotton purchased was sold at a price of twelve dollars less than the purchase price thereof. During the second season the same plan of operation as regards purchase and sale of cotton obtained as during the first season, that is, the plaintiff bank paid for the cotton as purchased holding the acceptances of the cotton company with the warehouse receipts as security; the bank then surrendered the warehouse receipts and accepted trust receipts in lieu thereof; then the cotton company sold the cotton and deposited the "outbound documents" in its general checking account and, so far as funds were available, drew checks from time to time at irregular intervals on its checking account and paid off certain of the acceptances held by the plaintiff bank. Each time an acceptance was paid the trust receipt attached thereto was surrendered by the bank.

During the second season of the cotton company's operations the plaintiff bank handled and paid for the cotton company 162 drafts aggregating a total of approximately two hundred thousand dollars, and during the period from November 17, 1920, to May 3, 1921, it held at one time or another said 162 drafts accepted by the cotton company with trust receipts attached thereto, all of the warehouse receipts having been surrendered to the cotton company at the time the trust receipts were given. Each time a check was drawn

by the cotton company on its general checking account in favor of the bank, it was applied in payment of the oldest acceptance held by the bank. It is not disputed that the cotton company paid 76 of the acceptances held by the plaintiff bank and secured a surrender thereof, together with the trust receipt attached thereto [page 433]. It is not disputed that the cotton company sold all of the cotton for which trust receipts were given to the plaintiff bank [page 441], and that all of the "outbound documents" covering every single bale of cotton sold and covered by the trust receipt held by the plaintiff bank, were deposited as a cash item in the checking account of the cotton company in plaintiff's bank [page 441], with the exception of 385 warehouse receipts which were still on hand in the safe of the cotton company at the time of Mr. Sears' death. At the time of Sears' death the plaintiff bank was holding 87 unpaid acceptances aggregating the face value of $82,487.96, to which were attached trust receipts calling for 1476 warehouse receipts for 1476 bales of cotton. As stated above, 385 of these warehouse receipts were later surrendered to the plaintiff bank, the remaining 1091 representing that number of bales of cotton, the original cost price of which was $60,628.72, had been sold by the cotton company, and the "outbound documents" therefor deposited as a cash item in the general checking account of the cotton company. Out of this general checking account the cotton company had paid its general operating expenses, as well as making payments from time to time on the acceptances held by the plaintiff bank.

As a result of the steady decline in the cotton market and the fact that the cotton company sold cotton purchased during the second season at a price averaging $12.00 per bale less than the actual cost thereof, the assets of the cotton company were depleted with the net result that at the time of Sears' death there was no money on hand with which to pay the unpaid acceptances at the bank, and the bank was left holding the 87 unpaid acceptances with trust receipts attached thereto covering 1476 bales of cotton; three hundred eighty-five warehouse receipts were later returned leaving 1091 undelivered.

It is stipulated by plaintiff bank and pleaded in its complaint that so far as the first cause of action is concerned all of the property of the cotton company was used by J. B. Sears for the purposes of the cotton company [page 376]; and it is not contended that any of the 1091 warehouse receipts for which the plaintiff bank held unredeemed trust receipts, or any of the proceeds from the sale thereof, were used by J. B. Sears personally or by any other person other than by the cotton company [page 377]. It is contended, however, that J. B. Sears, acting as secretary of the cotton company, did by his acts deceive and defraud the plaintiff bank in that he secured the delivery to the cotton company of the 1091 warehouse receipts with intent to convert to the cotton company's use; that he sold the cotton represented thereby, and failed to apply all the proceeds from the sale of such cotton, that is, the "outbound documents" to the payment of the acceptances and the discharge of the

trust receipts, but used same in general operation of the cotton company, and that as a result of such acts the 1091 bales of cotton covered by the unredeemed trust receipts were converted to the cotton company's use and were wholly lost to the plaintiff bank; and finally that the cotton company being "responsible" to the plaintiff bank for the cotton tickets so converted, a loss (to the extent of the cotton company's liability for such wrongful conversion) was sustained and that such loss was within the provision of the bond sued upon. The bond provides that the bonding company would "reimburse the employer (cotton company) for any loss not exceeding $50,000.00 of money, securities or other personal property (including that for which the employer may be responsible to others) which the employer shall have sustained by reason of any act or acts of fraud, dishonesty, forgery, embezzlement, wrongful abstraction or wilful misapplication on the part of the employee, while in the performance of his duties as secretary in the service of said employer and, occurring during the continuance of this bond."

During the first year the cotton company was owned by T. J. West. Later the ownership and control passed to J. B. Sears.

As stated by the learned judge of the District Court in his opinion [page 169]:

> "The cotton company was, from the date of its organization and until West transferred his interest therein, a business medium only used primarily for the benefit of West. West and Sears

were experienced cotton brokers. West was conducting a cotton brokerage business at Calexico, California, and Sears had come to Los Angeles after having been connected for a number of years with a large cotton brokerage concern in the south. West expected to and did devote his main energies to his business at Calexico, where he resided, which place was at the center of the cotton growing country of Southern California and Northern Mexico. Desiring to establish a Los Angeles cotton brokerage house, West and Sears, with the active assistance of McDevitt, organized the cotton company. West paid into the treasury of the company all of the money that was contributed in exchange for stock. There was some intimation that some others of the persons named as stockholders had contributed money or services, but as to whether that was the fact is doubtful. At any rate, it was quite clearly made to appear that the issuance of stock to all persons except West and Sears was for the particular purpose of qualifying them to act as directors. The stock certificates for one share each to McDevitt, Conduit and Hartke, remained undetached from the stock book, and so remained at the time of the trial."

Before the beginning of the second cotton season, that is, in the spring of 1920, West testified [page 393] that he decided to close out the cotton company's business and was then importuned by Sears to permit him to take over the business. Accordingly some time during the fall of 1920 (the date being first fixed by the trial court as September 1st, 1920, but later changed to December 1st, 1920) West sold and trans-

ferred to J. B. Sears the 496 shares of stock of the cotton company owned by West and at all times thereafter Sears was the owner of all said stock, and the cotton company was as found by the trial court [finding No. 21], from the date of the transfer by West to Sears of said capital stock, a corporation sole—to-wit, J. B. Sears. As stated in the opinion of the learned trial judge [page 177]:

> "We then must consider that from that date West owned no further interest in the business and that Sears then became the sole proprietor of it. Therefore, if there exists any liability on the part of the insurer under the bond sued upon, it must be such only as accrued prior to the first of September, 1920." (This date was later changed to December 1st, 1920.)

There was considerable testimony as regards the exact date when the transfer of stock from West to Sears was completed, the details of which will be discussed later herein.

The judgment rendered by the trial court in the principal sum of $24,321.97 represents the amount paid by the plaintiff bank for the cotton represented by the warehouse receipts surrendered to the cotton company prior to December 1st, 1920, and which were converted to the use of the cotton company instead of being returned to the bank.

It is urged by the bonding company (plaintiff in error) that the rights of plaintiff bank, as assignee of the cotton company, are no greater than the rights

of the cotton company so far as liability of the bonding company is concerned, and that

(a) While property of the plaintiff bank may have (as to the bank) been wrongfully converted or wilfully misapplied by the cotton company through the acts of J. B. Sears, its secretary, and by reason thereof the cotton company became liable to the bank for the financial loss it sustained, nevertheless the cotton company itself sustained no loss because it, the cotton company, received and used for its own purposes the very property belonging to the bank and which it is claimed was converted or misapplied.

(b) That if any cause of action existed in favor of the cotton company against the bonding company by reason of the loss (liability to the bank) sustained through the wrongful acts of J. B. Sears, its secretary, such cause of action ceased to exist when and as soon as the cotton company became a corporation sole—to-wit, J. B. Sears. It is not disputed that the assignment by the cotton company to the plaintiff bank of its cause of action, if any, on the bond was made after the cotton company became a corporation sole—to-wit, J. B. Sears.

At the time the bond in question was applied for the cotton company entered into certain promissory warranties with the bonding company, the strict performance of which was a condition precedent to liability on the bond. The plaintiff in error urges the breach by the cotton company of certain of these promissory warranties and particularly the failure on the part of the cotton company to have its books and accounts

audited and checked by T. J. West, as provided in the application for the bond.

It is also urged by plaintiff in error that the cotton company failed to notify the bonding company of its alleged loss within the time provided in the bond, and that such failure relieved the bonding company of liability.

Opinion of Trial Court.

The learned trial judge at the conclusion of the trial rendered a written opinion [page 168] and later two memorandum supplemental opinions [pages 181 and 183] wherein he discusses at considerable length the facts in the case. In substance the trial court in his opinion holds:

(a) That the cotton company was from its organization to the date of the transfer of stock by West to Sears, a business medium only through which West conducted his cotton brokerage business [page 169], and that the other four officers and directors were "dummy" directors, it appearing that one share of stock was issued to J. B. Sears, the remaining three shares, while made out in the name of the other directors were never removed from the stock certificate book.

(b) That about September 1st, 1920 (which date was later changed to December 1st, 1920), West turned over the ownership and control of the cotton company to Sears and from and after that date the cotton company was a corporation sole—to-wit, J. B. Sears. In its opinion [page 176] the trial court points

out that for the purpose of determining liability upon the bond, the question of transfer of the corporation from West to Sears should be considered in the light of *transfer of control* rather than exact date of the *transfer of the stock* certificates themselves. The portion of the opinion referred to is as follows:

> "Considering next the evidence as to the transfer of West's stock to Sears, and its effect upon the liability of the defendant: Remembering that, as has been already observed, the questions here are to be considered as though the cotton company was the plaintiff, the evidence of West, who was the owner of the cotton company, as to when he transferred his interest to Sears, must be allowed full weight. A different consideration might arise, were this an action by a creditor to enforce a stockholder's liability for corporate debts against West. If West, being the company, declares to the defendant: 'This corporation went under the ownership of Sears at a certain date, and Sears then came into full complete control' he would announce such a change in the conditions as to make the hazard different from that existing when the insurer made its bond. Furthermore, public policy would not favor the enforcement of a contract which would permit an individual to indemnify himself against his own misconduct.
>
> "West testified that he made the sale of his stock to Sears during the latter part of August. He contended also that it was a part of the agreement of sale that the transfer should be considered as relating back to the month of May, 1920, but I think, the evidence on the subject being considered altogether, the best conclusion that can be made is to fix the date of the transfer at the first of September, 1920. We then must consider that from that date West owned no further interest in the business, and that Sears

> then became the sole proprietor of it. Therefore, if there exists any liability on the part of the insurer under the bond sued upon, it must be such only as accrued prior to the first of September, 1920."

(c) That the first year of the cotton company's operations ending about May, 1920, was a good year and a considerable profit was made on the purchase and sale of cotton; that the second season, beginning in the fall of 1920, was a bad season, and that the purchase and sales accounts show a loss in a large amount.

(d) That pursuant to the arrangement made between the cotton company and the bank, as detailed in letter dated September 8, 1919 [page 178], Sears, as secretary of the cotton company, secured delivery to the cotton company of a large number of warehouse tickets substituting trust receipts; that during the second year on account of loss arising from sale of cotton at less than cost the cotton company became "hopelessly involved and owed the bank a sum considerably in excess of $50,000.00, which was wholly unsecured." That a later check showed that a large number of warehouse receipts, for which the plaintiff bank held trust receipts, had been sold by the cotton company and the proceeds used in its business for the payment of operating loss of the cotton company.

(e) That the acts of Sears, as secretary of the cotton company, in failing to return "outbound documents" covering the sale of cotton for which the plaintiff bank held trust receipts, was a breach of faith; the court says [page 179]:

> "it approached an embezzlement of collateral in which the bank held a qualified property interest * * * and the unauthorized use of the securities by Sears should be held to amount to a wilful misapplication of property for which the cotton company was responsible to the bank. Sears' breach of faith did result in a loss to the cotton company, because it would add to its liabilities the value of the collateral illegally withheld by Sears and used without authority in the business."

(f) That the fact that the property in which the bank held a qualified property interest and for which the cotton company was responsible, was received by, and the proceeds from the sale thereof devoted to the business of the cotton company, and not appropriated by Sears to his own use or to the use of any other person than the cotton company, was not a good defense for the reason that by reason of the misapplication of the property in which the bank had an interest, that is, the cotton tickets covered by the trust receipts, the cotton company became liable to the bank for the value thereof.

(g) That the liability of the cotton company to the plaintiff bank for the securities so misapplied to the cotton company's use by Sears as its secretary, constituted a loss to the cotton company, for which the bonding company is liable, but the court limits the extent of that liability to the amount of liability incurred prior to the date when the cotton company became a corporation sole, to-wit, J. B. Sears.

THE BILL OF EXCEPTIONS.

The Facts and Circumstances Surrounding the Preparation, Service, Proposing of Amendments and Settling of the Bill of Exceptions Were Sufficient to Justify the Trial Court in Allowing and Settling the Bill of Exceptions After the Term During Which the Judgment Was Rendered, and the Defendant in Error Is Estopped to Urge That the Settlement of the Bill of Exceptions After the Term Was Error. The Bill of Exceptions Should Be Considered a Part of the Record.

Upon the presentation for settlement of the bill of exceptions in the lower court objection was made that it had not been presented to the learned judge below for settlement and signing, nor was the same settled and signed, within the time allowed by law, or within the term of the court at which the judgment was rendered and entered. Since this objection will doubtless be renewed here we desire to state the reasons which, in our judgment, justified the trial court in settling and signing the bill of exceptions and ordering that it be made a part of the record herein.

The relevant facts, all of which appear in the affidavit of Dale H. Parke [pages 483-493] and which are not disputed by the affidavit filed by counsel for defendant in error, are as follows:

Judgment was entered on the 7th day of March, 1925; by stipulation of counsel and order of court,

the time within which defendant might prepare, serve and file its bill of exceptions was regularly and in good time extended to and including the 15th day of June, 1925 [pages 514-517]; the proposed bill of exceptions was duly served and filed on June 10, 1925. It then became the duty of the plaintiff below to prepare and present its proposed amendments and with this object in view and at plaintiff's request, a stipulation [page 518] was entered into extending plaintiff's time to prepare, serve and file its proposed amendments until the 9th day of July, 1925. The term of court during which the judgment was entered expired at midnight on July 12, 1925. On the afternoon of July 8th, plaintiff served and filed "Proposed Amendments to the Bill of Exceptions" which said proposed amendments contained 296 proposed amendments covering 59 typewritten pages; that upon receipt of the proposed amendments, counsel for defendant communicated by telephone with counsel for plaintiff to arrange, if possible, for a conference with a view of agreeing upon the proposed amendments, and thereupon counsel for plaintiff stated to counsel for defendant:

"That the proposed amendments were prepared by two young men in our office during my absence and they may have been over cautious, and I suggest that you check the proposed amendments, indicating those you think are proper and those you think ought not to be allowed and return your copy of the proposed amendments with your notations thereon and I will check them over within the next few days and let you know which ones we will insist upon."

That pursuant to said request counsel for defendant checked the proposed amendments, the time for checking same requiring several days, and did on the 15th day of July, 1925, return, at request of counsel for plaintiff the copy of proposed amendments theretofore served upon defendant, with notations thereon as to the proposed amendments which the defendant would consent to. The returned copy of the proposed amendments was accompanied by letter dated July 15, 1925 [page 486]; that thereafter and between July 15, 1925, and July 22, 1925, counsel for defendant called one of the counsel for plaintiff on two occasions by telephone and was advised that the proposed amendments were being rechecked by plaintiff's counsel and would be ready for resubmission within a day or two; that on July 22, 1925, plaintiff's counsel resubmitted its proposed amendments, having stricken out a large number of the amendments originally proposed, and adding some new ones. The new set of proposed amendments was accompanied by letter written by plaintiff's counsel [page 488]; that the new proposed amendments were not received by counsel for defendant until late in the afternoon of July 22d, and on the morning of July 23d, one of the counsel for plaintiff called counsel for defendant and requested that a conference be held with a view of agreeing upon the amendments as then proposed, and to that end counsel for plaintiff and defendant devoted a substantial portion of July 23d and 24th in going over the proposed amendments and an agreement was had on substantially all amendments proposed; that at the time the original bill of exceptions was served certain

exhibits were omitted and counsel for plaintiff agreed at that time to indicate what portions of such exhibits they desired printed in the record, which information was not furnished to counsel for defendant until the 25th day of July, 1925. The particular exhibits to which reference is made were the minutes of the cotton company and certain auditor's reports. There was not sufficient time between the 8th day of July, 1925, when the original set of proposed amendments were served on counsel for defendant, and Saturday night, July 11th, (the term expiring on Sunday night) within which the proposed amendments might have been made had they been approved of by counsel for defendant as the amendments originally proposed required a rewriting of substantially the whole bill; that counsel for defendant relied upon the request of counsel for plaintiff that the proposed amendments as originally served be returned for correction by plaintiff's counsel, and upon the conduct of counsel for plaintiff, as set forth in the affidavit of Dale H. Parke above referred to. That a final agreement between counsel as to all the proposed amendments was not arrived at until Saturday, July 25th. Whereupon, a public stenographer was employed and not less than two full days was required to rewrite the proposed bill in accordance with the amendments agreed upon. That of the amendments originally proposed by plaintiff approximately 121 were later by agreement of plaintiff's counsel waived. Upon due notice, the bill of exceptions as rewritten in accordance with the proposed amendments as agreed upon between counsel was on the 28th

day of July, 1925, presented to the court for settlement and allowance. Objections were made to the settlement on the grounds that the court was without authority to settle the bill of exceptions, the term of court during which judgment was rendered having expired, and the legal question involved was heard. Whereupon the trial court signed and settled the bill of exceptions and entered an order making said bill of exceptions a part of the record herein. [Page 509.]

While it is the general rule that the bill of exceptions must be signed and settled within the term of court during which the judgment is entered, such rule is not *jurisdictional.* The court has power in its discretion, where facts justify the exercise of such discretion, to settle the bill after the term. This rule is recognized by a long line of cases, some of which have been decided by this court.

Pacific Bank v. Hanna, 90 Fed. 76;
Sutherland v. Pearce, 186 Fed. 783.

That the settling of the bill of exceptions within the term is not jurisdictional is recognized by a great many United States Supreme Court decisions, beginning with:

United States v. Breitling, 20 Howard 253—15 L. Ed., page 900.

See also

Hume v. Bowie, 148 U. S. 245-253—37 L. Ed. 438.

In the foregoing cases the courts hold that if a bill is filed within the term the settlement thereof

may, where circumstances warrant, be made after the expiration of the term. See also

Koewing v. Wilder, 126 Fed. 473;
Harrison v. German American Fire Ins. Co., 90 Fed. 758.

Under the circumstances as detailed in the record, [pages 483 to 520], and in view of the stipulations and conduct of counsel for plaintiff, the plaintiff is estopped from objecting to the settlement of the bill of exceptions after the expiration of the term.

Re Chateaugay Ore & Iron Co., 128 U. S. 544—32 L. Ed. 508;
Du Pont etc. v. Smith, 249 Fed. 403.

Counsel for plaintiff urged to the trial court that the writ of error having been granted and citation issued prior to the presentation of the bill of exceptions but before the cause had been docketed and record filed in the appellate court, the trial court was without jurisdiction to settle the bill.

On this point we respectfully submit the following authorities which hold in accordance with the law as stated in Foster on Federal Practice, 5th Edition, Volume 3, page 1594, as follows:

> "A bill of exceptions if otherwise in time may be signed after a writ of error has been sued out, or an appeal allowed and citation issued, or a supersedeas bond filed and approved."

Hunnicutt v. Peyton, 102 U. S. 333, 357—26 L. Ed. 113, 117;
Davis v. Patrick, 122 U. S. 138, 30 L. Ed. 1090;
Cook v. Klonos, 164 Fed. 529 (9th Circuit);
Ulmer v. U. S., 266 Fed. 176.

We respectfully submit that the trial court was justified in settling and allowing the bill of exceptions and that the enforcement of the common law rule that the bill should be settled within the term should not be enforced so rigidly that it will work injustice, and particularly in a case where, as in the present case, counsel for defendant was not at fault and the conduct of counsel for plaintiff was such as should estop plaintiff from urging that the bill of exceptions be not settled. As stated by the learned trial judge in the order settling the bill of exceptions [page 510]: "between the said 9th day of July, 1925, and the date of this order negotiations toward an agreement between counsel, covering the proposed amendments, were pending and said proposed amendments were not finally agreed upon between the parties until the 25th day of July, 1925."

After full consideration the trial court considered that good cause existed for the settlement of the bill of exceptions and the ends of justice will be better served by having the bill of exceptions considered as a part of the record.

Motion for Non-Suit and Motion for Judgment in Favor of Defendant and Special Findings in Favor of Defendant Were Requested in the Trial Court.

At the conclusion of plaintiff's testimony, the defendant moved for a non-suit [page 377]. Said motion was based upon the following grounds:

(a) That there was not sufficient evidence to warrant a finding of fact by the trial court that the cotton company had sustained any loss within the meaning of the bond sued upon, it appearing affirmatively from the testimony introduced by plaintiff that all money and property received by Sears and which came into his hands in trust as an employee of the cotton company, was fully accounted for and applied to the use and business of the cotton company.

(b) That there was no evidence to support any finding of fact as to the value of the securities—to-wit, warehouse receipts or cotton tickets which plaintiff claims were misapplied by J. B. Sears and for which misapplication the cotton company was liable to the plaintiff bank.

(c) That it affirmatively appeared from the testimony introduced in evidence by the plaintiff that the cotton company failed to comply with the promissory warranty regarding the auditing and inspecting of the books by T. J. West in that the cotton company failed to have the books, accounts, stocks and securities inspected, audited and approved each month by T. J. West.

At the conclusion of the taking of testimony the defendant made request of the trial court for special findings of fact on the issues [page 467] and also presented to the trial court a motion that the court enter findings and judgment in favor of the defendant upon the following grounds, among others, [pages 462-466]:

(a) That the first cause of action in plaintiff's complaint as amended does not state facts sufficient to constitute a cause of action.

(b) That the evidence is insufficient in that there is no evidence that J. B. Sears converted to his own use or to the use of any person, partnership or corporation any of the money, property, rights or credits of the cotton company, other than to the use of the cotton company.

(c) That the evidence is insufficient in that there is no evidence legally sufficient to show that the cotton company sustained any loss by reason of any of the wrongful acts of J. B. Sears while in the performance of his duties as secretary.

(d) That the evidence shows that the cotton company at all times knew of the acts being performed by J. B. Sears and which it is alleged were wronful and caused the loss sought to be recovered, and that the cotton company failed to notify the bonding company within the time expressly provided in the bond of such act or acts so done and performed by J. B. Sears.

(e) For the reason that the evidence shows that the cotton company failed to have its books, accounts, stocks and securities inspected, audited and verified with funds on hand or in the bank each month by T. J. West, treasurer, as required under the bond and application made in connection therewith.

(f) That the evidence shows that during all the period of time, in which the alleged wrongful acts of

J. B. Sears were performed and which it is claimed resulted in a loss to the cotton company, the said J. B. Sears was the owner of all the capital stock of the cotton company and said cotton company was in fact a corporation sole—to-wit, J. B. Sears; and that at all times after the transfer by T. J. West to J. B. Sears of his stock interest said cotton company was a corporation sole—to-wit, J. B. Sears, and, therefore, the cotton company could not recover from the bonding company for any alleged loss since to do so would be to permit the said J. B. Sears to recover for a loss resulting from his own wrongful acts.

The Motions and Request for Special Findings of Fact Were by the Trial Court Denied and Exceptions Thereto Allowed. (Page 117.)

Assignments of Error.

Now comes the above named defendant, plaintiff in error herein, and says that in the record and proceedings in the above entitled action there is manifest error, and now makes, presents and files the following assignments of error upon which it will rely, as follows, to-wit:

I.

That the first cause of action as set forth in plaintiff's original complaint as amended by the amendments thereto does not state facts sufficient to constitute a cause of action against the defendant herein and the court erred in over-ruling defendant's demurrer thereto.

II.

The court erred in over-ruling defendant's motion for non-suit and defendant's motion that the court enter findings and judgment in favor of the defendant.

III.

The evidence received upon the trial of the above entitled action was and in wholly insufficient to justify the findings of the trial court that the California Cotton & Factorage Company sustained any loss of any kind or character by reason of any fraud, dishonesty, forgery, embezzlement, wrongful abstraction or wilful misapplication by J. B. Sears while in the performance of his duties as secretary of the said California Cotton & Factorage Company.

IV.

The evidence received upon the trial of the above entitled action was and is wholly insufficient to justify the finding of the trial court as set forth in finding of fact No. VI that the said J. B. Sears applied to and secured from the plaintiff the warehouse receipts

> "with the intent then and there by him entertained of fraudulently and dishonestly converting, misappropriating, and wilfully misapplying said warehouse receipts, the cotton represented thereby, and any money or proceeds obtained therefrom, and with the further fraudulent and dishonest intent then and there by him entertained, of thereby causing a loss to said California Cotton & Factorage Company of money, securities, and personal property for which it would be and has become responsible to the plaintiff herein."

V.

There is no evidence to justify that part of the finding of the court No. VI insofar as the court finds that the said J. B. Sears at the time of executing the trust receipts and securing delivery to him of the warehouse receipts, or cotton tickets, made any other or different representations to the plaintiff or any of its officers than the representations set forth in the letter of September 8, 1919, written by the Calinornia Cotton & Factorage Company to the plaintiff bank, being Plaintiff's Exhibit No. 5.

VI.

There is no evidence to justify that part of finding of fact of the court No. VI wherein the court found that

> "and pursuant to said fraudulent and dishonest plan and scheme said J. B. Sears at various times and irregular intervals procured from the plaintiff herein between the 19th day of November, 1920 and said 25th day of April, 1921, 1,476 warehouse receipts for 1,476 bales of cotton and issued and delivered to the plaintiff in acknowledgement thereof 87 of said trust receipts."

for the reason that the evidence shows that the securing of said warehouse receipts for 1,476 bales of cotton and the issuance and delivery of the 87 trust receipts therefor was done and performed by said J. B. Sears with the consent and knowledge of the plaintiff and pursuant to and in strict keeping with the plan of operations entered into and agreed upon by and be-

tween the plaintiff and the California Cotton & Factorage Company as evidenced by the letter of September 8, 1919, plaintiff's Exhibit No. 5.

VII.

There is no evidence to justify that part of finding of fact of the court No. VII to the effect that said J. B. Sears

> "without the knowledge of said California Cotton & Factorage Company, or any of its officers or agents other than J. B. Sears, pursuant to said fraudulent and dishonest plan and scheme by him entertained as hereinbefore found, fraudulently and dishonestly converted, misappropriated and wilfully misapplied 1,091 of said 1,476 warehouse receipts and 1,091 bales of cotton represented thereby."

VIII.

There is no evidence to justify that part of finding of fact of the court No. VII that said J. B. Sears in performing the acts as set forth in said finding No. VII violated any of his duties as secretary or violated any of the promises and representations made by him to the plaintiff or that in depositing outbound drafts covering cotton sold, he, the said J. B. Sears, made any misrepresentations to the officer or officers of the plaintiff bank or caused said sight drafts to be deposited as cash items in the account of the California Cotton & Factorage Company for the purpose of defrauding or cheating the plaintiff bank or of defrauding or cheating the plaintiff or said California

Cotton & Factorage Company or of misapplying or misappropriating any of its property.

IX.

There is no evidence to support that part of the finding of fact of court No. VII that the said J. B. Sears pursuant to said alleged fraudulent scheme or otherwise or at all falsified the books and accounts of the California Cotton & Factorage Company in the manner as set forth in finding of fact No. VII or otherwise or at all and particularly that he falsified the books and accounts of the said California Cotton & Factorage Company by entering or causing to be entered therein the various amounts of money received from the sales of cotton and carrying same upon the bank pass book as monies and funds belonging entirely without limitation of any kind to the said company; or that he wilfully failed to enter in the books of said company any entry or memorandum indicating that trust receipts had been issued to the plaintiff covering the cotton that was being sold and disposed of or that he wilfully failed to make or cause to be made any entry or memorandum indicating that the monies received from the sale of cotton was charged with any trust or were in any manner monies or funds other than the absolute and unencumbered funds of the said Cotton Comuany.

X.

There is no evidence to support that part of finding of fact of the court No. VII that said J. B. Sears frequently represented to the California Cotton & Fac-

torage Company, its officers and directors, that the various sums of money and credits entered upon the bank pass book and books of account of the Cotton Company were the funds and monies of the said Cotton Company or to the effect that the plaintiff or said California Cotton & Factorage Company, or any of its officers and directors, relied upon or were deceived by any dishonest or false and fraudulent representations made to them by said J. B. Sears.

XI.

That there is no evidence to support or justify that part of finding of fact of the court No. VII that the 1,091 bales of cotton sold and disposed of by the Cotton Company and for which the plaintiff held trust receipts was at the time the same was sold and disposed of, of the reasonable value of $60,594.62 or any part thereof or any sum whatsoever.

XII.

There is no evidence to support or justify that portion of finding of fact of the court No. VIII that said J. B. Sears did secure possession of the warehouse receipts held by plaintiff as collateral security by any false or fraudulent representations or that in selling and disposing of the cotton covered by trust receipts held by the plaintiff the said J. B. Sears acted in a fraudulent or dishonest manner or was guilty of any conversion, misappropriation or wilful misapplication of said warehouse receipts or of the cotton covered thereby, and that said J. B. Sears in selling and disposing of said cotton or in disbursing the

proceeds realized from the sale thereof was acting in a false or fraudulent manner or practicing any deceit upon the plaintiff or upon the California Cotton & Factorage Company.

XIII.

There is no evidence to support or justify that part of finding of fact of the court No. VIII that said J. B. Sears

> "fraudulently and dishonestly converted, misappropriated and wilfully misapplied the monies and funds placed to the credit of the said California Cotton & Factorage Company following the dishonest and fraudulent sales of cotton and disposition of warehouse receipts and bills of lading, all as herein found, by using said monies and funds for the purpose of dealing and speculating in cotton in the name of the said California Cotton & Factorage Company and conducting such dealings and speculations at a loss and paying said losses out of said monies and funds and in the payment of claims and demands incurred by said J. B. Sears in said dealings and speculations in cotton."

XIV.

There is no evidence to support or justify that part of the finding of fact of the court No. VIII that

> "relying entirely upon said false and fraudulent representations of said J. B. Sears herein found and said deceits by him practiced upon it and them as herein found, said California Cotton & Factorage Company, its directors and officers, continued the business of said California Cotton &

Factorage Company and consented to said J. B. Sears, subsequent to said 19th day of November, 1920, continuing to act as the secretary of said company—and to continue to deal and speculate in cotton and to incur indebtedness and contract financial obligations in connection therewith as herein found."

XV.

There is no evidence to justify or support that portion of finding of fact of the court No. IX that the California Cotton & Factorage Company sustained any loss or has become responsible to the plaintiff herein in the sum of $60,594.62, or any sum of money whatsoever, with interest thereon by reason of any fraud, dishonesty, wrongful abstraction and wilful misapplication of said 1,091 warehouse receipts, and/or the cotton held thereunder, and/or said bills of lading, and/or the money proceeds and credits realized from the sale thereon but on the contrary said evidence shows that said indebtedness existing in favor of the plaintiff against the California Cotton & Factorage Company was incurred pursuant to and in strict keeping with the plan of operations agreed upon between the plaintiff and the California Cotton & Factorage Company as evidenced by the letter of September 8, 1919, Plaintiff's Exhibit No. 5, and that all of the monies received from the sale of the said 1,091 bales of cotton was received by and deposited in plaintiff bank to the credit of the California Cotton & Factorage Company and no part of said cotton evidenced by said 1,091 warehouse receipts or any of the monies

realized from the sale thereof was lost to the California Cotton & Factorage Company.

XVI.

That there is no evidence to support or justify any finding by the trial court that the said J. B. Sears in securing the 1,476 warehouse receipts from the plaintiff and issuing and delivering to plaintiff in acknowledgment thereof 87 trust receipts or in selling and disposing of 1,091 bales of cotton evidenced by said warehouse receipts and covered by said trust receipts was acting pursuant to any fraudulent or dishonest intent or design on his part or in violation of any agreement or representations made by him or by the California Cotton & Factorage Company to the plaintiff in relation to said warehouse receipts and the cotton covered thereby. The evidence conclusively shows that the securing of said warehouse receipts and the issuance of trust receipts to the plaintiff was known to and approved of by the officers and directors of the plaintiff and of the California Cotton & Factorage Company.

XVII.

There is no evidence to support or justify any finding of the trial court that said J. B. Sears in depositing the "outbound documents" covering the sale of cotton for which the plaintiff bank held trust receipts as a cash item to the credit of the California Cotton & Factorage Company was acting pursuant to any fraudulent or dishonest intent or design on the part of the said J. B Sears for the reason that on the contrary the

evidence shows that the officers and directors of the plaintiff and of the California Cotton & Factorage Company knew and approved of the handling of the sale of said cotton and the disbursement of the funds realized thereupon in the manner in which the same were handled by said J. B. Sears.

XVIII.

There is no evidence to support or justify the finding of fact of the court No. X that within ten days after the California Cotton & Factorage Company discovered the alleged loss claimed to have been sustained by it, it notified the defendant herein of said alleged loss and of the facts in connection therewith.

XIX.

There is no evidence to justify or support the finding of fact of the court Nos. XIV and XV that J. B. Sears was not allowed and permitted by the California Cotton & Factorage Company as he deemed best.

XX.

There is no evidence to support or justify that part of the finding of fact of the court No. XVI that T. J. West, treasurer of said California Cotton & Factorage Company,

> "visited the office of the said California Cotton & Factorage Company semi-monthly during the term of said bond as herein found and at such times conferred with J. B. Sears respecting the business of said Company and checked over the

books of said Company but not in detail at any time examining the cotton account, being the purchase and sales cotton account, showing the cotton bought and sold and at said times examined the records disclosing the amount of cotton bought, the amount of cotton sold, the number of bales unsold, the entries respecting the hedging of the same, and also examined the cash account and the acceptance account, together with the cotton tickets indicating the number of bales of cotton on hand and compared the same and determined that they corresponded to the acceptances in the plaintiff bank and that at such times said T. J. West checked the books of said Company for the purpose of determining the amount of money owing by said Company to said Citizens National Bank and examined the statements and books of said Company and did observe the amount of cotton purchased, the number of cotton tickets and bales of cotton on hand, and examined the ledger books of said company and the various accounts therein including the cotton account, and checked the same with the bookkeeper's statement furnished at the end of each month.";

or that

"that said T. J. West checked the accounts of said company, including the bank account, semimonthly by said statements rendered by the bookkeeper as herein found"

or that

"that it is not true that if an audit had been made each month as provided in the contract between the California Cotton & Factorage Company and said defendant it would have revealed the facts

as herein found and that the loss herein found to have been sustained could have been checked, lessened and stopped."

XXI.

There is no evidence to support or justify that portion of finding of fact of the court No. XVII that the California Cotton & Factorage Company or the plaintiff herein did not discover the alleged loss claimed to have been sustained by the California Cotton & Factorage Company by the alleged acts of J. B. Sears until the 19th day of May, 1921.

XXII.

There is no evidence to justify or support the finding of fact of the court No. XIX that it is not true that all of the monies of the California Cotton & Factorage Company handled by J. B. Sears were used in and for the purchase of cotton and other commodities for the Cotton Company or for the purpose of paying the expenses or costs of operation of the Cotton Company.

XXIII.

There is no evidence to support or justify that portion of finding of fact of the court No. XIX that the warranties made by the California Cotton & Factorage Company to the defendant in the application for bond were not untrue or were not broken in all or any of the respects as alleged in defendant's answer; or that the defendant is or has not been released from all or any of the obligations of liability to plaintiff

under said bond sued upon herein; or that the California Cotton & Factorage Company has not breached any of the warranties of said bond or done anything contrary to or in violation of the terms of the application for said bond.

XXIV.

There is no evidence to support or justify the finding of fact of the court No. XX that the alleged loss to the California Cotton & Factorage Company was not incurred with the full knowledge of the officers and directors of said Cotton Company and with their consent.

XXV.

There is no evidence to justify or support that portion of the finding of fact of the court No. XXI that the sale and transfer by T. J. West of 496 shares of stock to said J. B. Sears occurred on the 1st day of December, 1920, or at any date subsequent to the 17th day of November, 1920; or that it was only on and after December 1, 1920, that J. B. Sears became and was the practical owner of the entire assets and business of said Cotton Company.

XXVI.

There is no evidence to support or justify that part of the finding of fact of the court No. XXIV that the 455 bales of cotton covered by sight drafts accepted by the plaintiff prior to December 1, 1921, were at the time the same were disposed of by J. B. Sears had the reasonable value of $29,337.99 or any part thereof or any sum whatsoever.

XXVII.

That the court erred in its conclusions of law in finding that the plaintiff is entitled to judgment against the defendant on its first cause of action in the sum of $24,321.97, together with interest thereon or any sum whatsoever.

XXVIII.

That the court erred in giving, making, rendering, and filing its judgment in the above-entitled action in favor of the plaintiff and against the defendant in this, that said final judgment was and is contrary to law and to the cause made and facts stated in the pleadings and records in said action.

XXIX.

That the court erred in failing and refusing to make findings of fact herein in accordance with the "Request for Special Findings of Fact" as made by the defendant to the trial court prior to the submission of said case for the court's decision, and which "Request for Special Findings" is set forth in the transcript of the record herein.

XXX.

That the court erred in failing to find as a fact that T. J. West sold and transferred to J. B. Sears 496 shares of the capital stock of the California Cotton & Factorage Company on or prior to the 17th day of November, 1920, and that at all times on and after November 17, 1920, said California Cotton & Factorage Company was a corporation sole, to-wit, J. B.

Sears, and under his exclusive management and control.

XXXI.

That the court erred in failing to find as a fact that the said California Cotton & Factorage Company failed to do and perform those promises and warranties set forth in the application for bond made by said California Cotton & Factorage Company to defendant in that the said California Cotton & Factorage Company did not by and through its treasurer, T. J. West, cause the books and records of said California Cotton & Factorage Company to be inspected and audited and verified with funds on hand or in bank as expressly provided for in paragraph 12 of the application made by the said California Cotton & Factorage Company to the defendant for said bond.

In order that the foregoing assignments of error may appear of record said defendant presents the same to said court and prays that such disposition be made thereof as is in accordance with law and the statutes of the United States in such cases made and provided; and said defendant, plaintiff in error herein, prays the reversal of the above mentioned final judgment heretofore given, made, rendered, entered and filed in the above entitled court in the above-entitled action.

POINTS OF PLAINTIFF IN ERROR.

I.

THE COTTON COMPANY SUSTAINED NO LOSS BY REASON OF THE ALLEGED ACTS OF J. B. SEARS, ITS SECRETARY, IN WRONGFULLY CONVERTING OR WILFULLY MISAPPLYING THE 1091 WAREHOUSE TICKETS OR THE COTTON REPRESENTED THEREBY AND WHICH WERE COVERED BY UNREDEEMED TRUST RECEIPTS HELD BY PLAINTIFF BANK, AND THE COURT ERRED IN FINDING THAT ANY SUCH LOSS WAS INCURRED BY THE COTTON COMPANY.

ASSIGNMENTS OF ERROR NOS. 1, 2, 3, 15, 22, 27, 28 AND 29.

II.

THE FIRST CAUSE OF ACTION OF PLAINTIFF'S COMPLAINT AS AMENDED DOES NOT STATE FACTS SUFFICIENT TO CONSTITUTE A CAUSE OF ACTION AGAINST DEFEFNANT BONDING COMPANY, AND THE TRIAL COURT ERRED IN OVERRULING DEFENDANT'S DEMURRER THERETO AND IN REFUSING TO FIND JUDGMENT FOR THE DEFENDANT.

ASSIGNMENTS OF ERROR NOS. 1 AND 2.

III.

THERE IS NO EVIDENCE TO SUPPORT OR JUSTIFY THE FINDINGS OF THE TRIAL COURT AS SET FORTH IN FINDINGS NO. VII THAT THE REASONABLE VALUE OF THE 1091 BALES OF COTTON SOLD AND DISPOSED OF BY THE COTTON COMPANY AND FOR WHICH THE PLAINTIFF BANK HELD TRUST RECEIPTS, WAS AT THE TIME THE SAME WERE SOLD AND DISPOSED OF, OF THE REASONABLE

VALUE OF $60,594.62; OR TO SUPPORT FINDING NO. XXIV THAT THE 455 BALES OF COTTON COVERED BY WAREHOUSE RECEIPTS DELIVERED BY PLAINTIFF BANK TO THE COTTON COMPANY PRIOR TO DECEMBER 1ST, 1920, AND NOT RETURNED TO THE BANK WERE AT THE TIME THEY WERE SOLD AND DISPOSED OF, OF THE REASONABLE VALUE OF $29,336.99.

ASSIGNMENTS OF ERROR NOS. 11 AND 26.

IV.

THE COTTON COMPANY DURING THE LATTER PART OF 1920 BECAME A CORPORATE SOLE—TO-WIT, J. B. SEARS, AND THEREAFTER J. B. SEARS, THE "RISK" NAMED IN THE BOND, WAS IN COMPLETE OWNERSHIP AND CONTROL OF THE COTTON COMPANY. THAT ON AND AFTER THE DATE WHEN SUCH COMPLETE OWNERSHIP AND CONTROL WAS OBTAINED BY J. B. SEARS THE COTTON COMPANY—TO-WIT, J. B. SEARS, HAD NO RIGHT OF ACTION TO RECOVER FOR ANY LOSS SUSTAINED BY THE WRONGFUL ACTS OF J. B. SEARS, WHETHER COMMITTED PRIOR TO OR SUBSEQUENT TO THE DATE ON WHICH THE OWNERSHIP AND CONTROL OF THE COTTON COMPANY WAS ACQUIRED BY SEARS. FOR THAT REASON THE TRIAL COURT ERRED IN FINDING JUDGMENT FOR PLAINTIFF AND IN REFUSING TO GRANT DEFENDANT'S MOTION FOR JUDGMENT FOR DEFENDANT. IN VIEW OF THE FINDING OF FACT THAT THE COTTON COMPANY BECAME A CORPORATION SOLE—TO-WIT, J. B. SEARS, ON DECEMBER 1ST, 1920, THE TRIAL COURT ERRED IN ITS CONCLUSIONS OF LAW THAT THE PLAINTIFF (ASSIGNEE FOR COLLECTION OF THE COTTON COMPANY) WAS ENTITLED

TO JUDGMENT FOR ANY LOSS RESULTING FROM THE WRONGFUL ACTS OF J. B. SEARS.

ASSIGNMENTS OF ERROR NOS. 2, 25, 27, 28 AND 30.

V.

THE COURT ERRED IN ITS FINDING OF FACT THAT THE CONTROL OF THE COTTON COMPANY DID NOT PASS FROM WEST TO SEARS UNTIL DECEMBER 1ST, 1920.

ASSIGNMENTS OF ERROR NOS. 25 AND 30.

VI.

THERE WAS A BREACH BY THE COTTON COMPANY OF THE PROMISSORY WARRANTIES MADE TO THE BONDING COMPANY AND GIVEN AS CONSIDERATION FOR THE EXECUTION OF THE BOND, AND OF THE PROVISIONS OF THE BOND IN THAT THE COTTON COMPANY'S BOOKS, ACCOUNTS, STOCK AND SECURITIES WERE NOT INSPECTED AND AUDITED BY T. J. WEST, AS WARRANTED.

ASSIGNMENTS OF ERROR NOS. 31, 27, 28, 23, 20 AND 2.

VII.

THE COTTON COMPANY HAD KNOWLEDGE OF THE PERFORMANCE BY SEARS OF THE ACTS DONE BY HIM AS SECRETARY AND WHICH IT IS NOW CLAIMED WERE DISHONEST, FOR THE REASON THAT THE ACTS DONE BY SEARS AS EXPRESSLY PLEAD BY PLAINTIFF, WERE WITHIN THE SCOPE OF HIS DUTIES AS SECRETARY AND WERE FOR THE EXCLUSIVE BENEFIT OF THE COTTON COMPANY IN THE PROSECUTION OF THE BUSINESS FOR WHICH IT WAS INCORPORATED. IT IS NOT CLAIMED

THAT SEARS SOUGHT TO GAIN ANY PERSONAL ADVANTAGE OR BENEFIT TO HIMSELF OR TO ANY OTHER PERSON THAN THE COTTON COMPANY.

THE FAILURE OF THE COTTON COMPANY, HAVING KNOWLEDGE OF THE ACTS OF SEARS NOW COMPLAINED OF, TO NOTIFY THE BONDING COMPANY THEREOF WITHIN THE TIME PROVIDED IN THE BOND, PREVENTS ANY RIGHT OR RECOVERY THEREON AND ESTOPS THE COTTON COMPANY FROM MAINTAINING ANY ACTION PREDICATED UPON THE ALLEGED FRAUDULENT ACTS. IN VIEW OF THIS KNOWLEDGE ON THE PART OF THE COTTON COMPANY IT WAS ERROR FOR THE TRIAL COURT TO FIND THAT ANY FRAUD OR DECEIT WAS PRACTICED BY SEARS UPON THE COTTON COMPANY.

ASSIGNMENTS OF ERROR NOS. 18, 21, 24, AND 4 TO 17 INCLUSIVE.

A large number of the foregoing points touch upon the same subject matter and a portion of the facts, argument and law given in support of one point applies also to other points and should be considered therewith. The foregoing points are a general statement of the issues of fact and law involved and all assignments of error which relate to the same general issue are considered together.

I.

The Cotton Company Sustained No Loss by Reason of the Alleged Acts of J. B. Sears, Its Secretary, in Wrongfully Converting or Wilfully Misapplying the 1091 Warehouse Tickets or the Cotton Represented Thereby and Which Were Covered by Unredeemed Trust Receipts Held by Plaintiff Bank, and the Court Erred in Finding That Any Such Loss Was Incurred by the Cotton Company.

Assignments of Error Nos. 1, 2, 3, 15, 22, 27, 28 and 29.

The Facts.

The gist of plaintiff's first cause of action as pleaded and of the findings of fact as made by the trial court, and of the opinion of the learned trial judge is *that by the acts of fraud and misrepresentation J. B. Sears in his official capacity as secretary of the Cotton Company, obtained delivery to the Cotton Company from the plaintiff bank of* 1091 *warehouse receipts evidencing* 1091 *bales of cotton; that in violation of the agreement made by the Cotton Company with the bank, and in violation of the trust receipts executed by the Cotton Company in favor of the plaintiff bank, said Sears, as secretary of the cotton company, converted and wilfully misapplied as to the plaintiff bank, the said warehouse receipts, the cotton represented thereby, and the proceeds from the sale thereof, by selling the cotton and using the proceeds from the sale thereof in the general business of the cotton company, including pay-*

ment of its operating expenses, instead of paying over such proceeds to the bank in discharge of the trust receipts. It is expressly pleaded [see plaintiff's complaint, page 28], and is expressly admitted [page 376] that the total proceeds from the sale of the 1091 bales of cotton were deposited in the general checking account of the Cotton Company and used in the Cotton Company's business. It is not contended that any of said cotton, or the proceeds thereof, was wrongfully converted or misapplied as to the Cotton Company itself, but that the wrongful conversion and wilful misapplication was as to the plaintiff bank. It is contended by the plaintiff bank that by reason of the wrongful conversion and wilful misapplication by the Cotton Company through the acts of its secretary, J. B. Sears, of the 1091 warehouse receipts and the cotton and proceeds from the sale of cotton represented thereby, the Cotton Company became responsible (that is, liable) to the bank for the reasonable market value of the property so wrongfully misapplied to the Cotton Company's use instead of to the bank's use as agreed upon between the Cotton Company and the bank and as expressly provided in the trust receipt.

Irrespective of whether the acts of Sears were wilful or fraudulent, there can be no question but that the Cotton Company converted and applied to its own use the 1091 warehouse receipts and the cotton and proceeds from the sale of the cotton represented thereby and that by reason of such conversion it, the Cotton Company, became liable to the plaintiff bank in a sum equal to the reasonable value of the property. The

fact that such liability exists, however, does not for a single moment warrant the conclusion that the Cotton Company itself sustained any loss by reason of such liability having been incurred through the wrongful acts of its secretary. A liability equal, if not greater, already existed in favor of the plaintiff bank against the Cotton Company by reason of the fact that the plaintiff bank had advanced and paid for the Cotton Company's account the full purchase price of the 1091 bales of cotton. The day the purchase price drafts were paid that liability existed. Later the collateral securing this liability was surrendered to the Cotton Company and trust receipts given under which the Cotton Company agreed to return the collateral or the proceeds from the sale thereof. Instead of returning the property or the proceeds it sold the property and used the proceeds in its own business. By reason of this use, the Cotton Company became liable to the plaintiff bank for the value of the property so converted, but that value would be the reasonable market value of the property and for all general purposes might be considered to be identical in amount with the liability which already existed in favor of the bank by reason of its having advanced the money to the Cotton Company to purchase the cotton. As found by the trial court [finding No. XI, page 140], the plaintiff bank took judgment against the Cotton Company for the full amount of this liability—to-wit, the amount which the bank advanced for the Cotton Company in the purchase of the 1091 bales of cotton. It is true that the liability for moneys advanced by the

bank is a contractual liability, while the liability for the conversion of the warehouse receipts is a liability for damages. In either case, however, the Cotton Company received an amount equal to the measure of liability—that is, in the first case, it received the full benefit of the money advanced by the plaintiff bank on account of the purchase price of the cotton, and in the second case it received (converted to its own use) property of a value equal to its liability for the conversion thereof.

Without seeming to restate a self-evident proposition at too great length, it is respectfully submitted that the case is the same as if "A," an attorney, had in his employ one "B" as secretary, and "B," while acting within the scope of his duties as secretary, should wrongfully convert or misapply certain securities which had been entrusted to "A" by "C," one of his clients, and where "B" turned over to "A," his employer, the full value of the securities of "C" so wrongfully converted. In that case "A" could not recover on a fidelity bond covering "B" and which provided, as does the bond in question in this case that the bonding company would reimburse the insured for any loss of "money, securities or other personal property (including that for which the employer may be responsible to others)." In this case "A" would be responsible (liable) to "C" for the property so wrongfully converted by the employee "B," but "A" could not recover on the fidelity bond covering "B" for two reasons: First, because "A" suffered no loss by reason of having incurred the responsibility (liability) to "C," since he received prop-

erty belonging to "C" of a value equal to the liability; and second, because "A" could not be permitted to recover for any loss resulting from wrongful acts, he having received the full benefit of such wrongful acts.

The interpretations placed upon the bond by learned counsel for defendant in error and apparently by the trial court in its opinion is that the bond is broad enough to make the bonding company a guarantor of all liabilities contracted by the Cotton Company through the fraudulent practice of its secretary, J. B. Sears.

It is important to note carefully the terms of the bond which provide that the bonding company

> "shall reimburse the employer for any loss * * * which the employer shall have sustained by reason of any acts, etc."

Counsel for plaintiff bank interpret this language as synonymous with,

> "the bonding company will reimburse the employer for any liability which the employer shall have incurred by reason of any act or acts of fraud, etc."

Such a construction is wholly unwarranted. The word "loss" and "sustain" have well defined meanings and are not ambiguous. They are not synonymous with "liability" and "incur." To illustrate, if Sears with a fraudulent intent and desire to cause a loss to the Cotton Company and the bank had by false and fraudulent representations and while acting within the scope of his duties as secretary, borrowed from the plaintiff bank $100,000.00 and had diverted the

money to his own use or to the use of some party other than the Cotton Company, a *loss* would have been *sustained* by virtue of the fraudulent acts, and likewise a *liability* in favor of the bank would have been incurred against the Cotton Company in favor of the bank in the sum of $100,000.00. If, however, as in the case at bar, the $100,000.00 so acquired by Sears from the bank in the name of the Cotton Company was paid into the treasury of the Cotton Company and it received the full benefit thereof, the Cotton Company would *sustain* no *loss* but the liability of the Cotton Company to the bank would have been *incurred* and could be enforced.

It must be kept in mind that the bond in the present case is not in favor of the plaintiff bank and no liability on the bond can be predicated upon any loss of the bank, whether the loss arose out of the fraudulent acts of Sears or otherwise.

It was urged by learned counsel for defendant in error at the trial in the lower court that by reason of concealment of the facts regarding the true financial condition of the Cotton Company the other officers permitted the Cotton Company to continue its operations on a declining cotton market, and that such continuation of the business resulted in the Cotton Company losing all the proceeds which it realized from the sale of the 1091 bales of cotton which it received from the bank. The business of the Cotton Company was conducted in the same manner during the second year as it was during the first year. The financial results were different not by reason of the fact that Sears

handled the business of the Cotton Company in its dealings with the bank any different during the second year than during the first, but because during the first year the cotton market was rising, and during the second year it gradually declined from 40¢ to as low as 8¢ per pound, reaching the low point about the time of Sears' death.

Defendant in error urged to the trial court that Sears committed a fraud upon the Cotton Company in misrepresenting or concealing the fact during the second year that the Cotton Company was losing money and in misrepresenting the fact as to the cotton being hedged. Conceding for the sake of argument that such misrepresentations were made, such fact would not be a basis upon which a loss, for which the bonding company is liable, could be predicated. The entire management of the Cotton Company from its inception was in the hands of Sears, his power as secretary and general manager being unlimited; all questions regarding the operation of the Cotton Company were left to Sears. It is quite apparent that the other officers were satisfied with his management and conduct during the first year, notwithstanding the fact that he did business for the Cotton Company with the plaintiff bank the same way during the first year that he did during the second. If the cotton market had been a rising one during the second year and a net profit had been made instead of an operating loss, no criticism would have been made of Sears' conduct.

It is pleaded by plaintiff [page 50] and urged by plaintiff to the trial court that assets of the Cotton

Company, and particularly the proceeds from the sale of the 1091 bales of cotton which belonged to the bank, were lost to the Cotton Company by its speculation on the cotton market. The facts are the Cotton Company was at all times speculating—that is, buying at the market, and selling at the market. The very nature of its business was speculative. At no place in the record is it suggested that J. B. Sears was not a skilled broker, or that he did not at all times use good judgment in the purchase and sale of cotton. Admittedly, the 1091 bales of cotton in question were sold for the fair market price and the Cotton Company received the proceeds thereof. Thereafter, more cotton was bought and by reason of the declining market a deficit was incurred and the Cotton Company was unable to meet its obligation to the bank.

It was further urged that Sears committed a fraud on the Cotton Company by misrepresentations to the other officers that the cotton was being hedged. The question of whether cotton should or should not be hedged was left entirely to Sears, and the question of hedging is one on which brokers do not agree. "Hedging" is selling and buying cotton on the market at the same time the sales protecting the purchases, and vice versa. It limits the profit to a commission and often results in a loss equal to the commissions. The testimony of Mr. Norsworthy is that Sears received positive instructions from Mr. Neal of the McFadden Company, under whose guiding hand the brokerage business was being conducted, not to hedge,

and Norsworthy further testified that he had been in the cotton brokerage business for many years, and that it was not, in his opinion, good practice to hedge.

It was further urged by defendant in error that Sears committed a fraud upon the Cotton Company by not advising the other officers that the proceeds from the sale of cotton covered by trust receipts were being used for payment of general operating expenses. The exclusive management of the Cotton Company was entrusted by the other officers to Sears and that Sears did the best he could in view of the falling market and lived in the hope of a turn in market conditions, is not disputed. It was the vicissitudes of the cotton market that brought about the disastrous result.

All the foregoing complaints regarding the good faith of Sears toward the Cotton Company, however, are not material in view of the fact that the loss which the plaintiff bank seeks to recover is the loss (liability) of the Cotton Company to the plaintiff bank by reason of the conversion to the Cotton Company's use of the 1091 bales of cotton, for which the bank held trust receipts. *The loss sought to be recovered herein is not predicated upon any operating loss incurred by the Cotton Company during the time that Sears was managing the company.* If so, then what portion of that loss was incurred before December 1st, 1920, when Sears became the owner of the corporation, and what portion was incurred thereafter? This question cannot be answered from the record. As stated, such operating loss of the Cotton Company, however, is

not the basis of loss sued for in plaintiff's first cause of action.

A considerable portion of the record is devoted to proof of Sears' concealment of facts from the other officers of the Cotton Company and of his breach of the trust receipts and agreements made by the Cotton Company with the plaintiff bank. There is no evidence of any kind or character that Sears ever prior to a short time before his death, spoke a single word to any officer of the plaintiff bank concerning the securing delivery of the cotton tickets and the substitution of trust receipts, or concerning the sale of the cotton and the disposing of the proceeds in the checking account, other than that Sears made the initial arrangement for handling the finances of the Cotton Company at the bank as set forth in the letter of September 8, 1919.

Mr. Ivy, in charge of the note department of plaintiff bank, one of the principal witnesses for the plaintiff, does not testify to any conversations had with Sears in relation to the transaction between the Cotton Company and the bank, except those that occurred shortly prior to Sears' death, and long after the alleged loss was incurred. Likewise, Mr. Pettigrew and Mr. Rugg, vice presidents of the plaintiff bank, each testified that no representations were made to them by Sears concerning the handling of the securities, etc. They were the only officers of the plaintiff bank whose testimony was introduced.

Mr. Norsworthy testified [page 457] that he was the one who took the first "outbound documents" to

the plaintiff bank and secured the "OK" of a vice president and deposited it as a cash item, and that it was he who usually attended to the drawing of checks and the payment of acceptances and securing return of trust receipts. He testified [page 403] that he did this, not under instructions from Sears, but because it was the usual and customary way of handling the business, being the method which was employed by many large brokerage concerns with whom he had been employed. Likewise, Mr. West testified [page 341] that the manner in which the Cotton Company handled its business with the bank during its two years of operations was in accordance with the usual manner of dealing between banks and cotton brokerage concerns and met with his approval. Mr. McDevitt testified [page 273] as well as did Mr. West [page 340] that the plan of operations between the Cotton Company and the bank, as outlined in the letter of September 8, 1919, was known to them and met with their approval; that they knew and approved of the delivery by the bank to the Cotton Company of the warehouse receipts and the substitution of trust receipts therefor. that they knew and approved of the sale of the cotton and the depositing of the proceeds of sale by the cotton company in its general checking account [page 343]; and that the only thing in the whole plan of operation between the cotton company and the bank that they did not know and would have disapproved of was that any portion of the proceeds from the sale of cotton for which the plaintiff bank held trust receipts should be used for

purposes other than payment to the plaintiff bank in discharge of the trust receipts, and that they [page 344] would not have approved had they known that the general operating expenses of the cotton company were being paid out of the proceeds of cotton covered by the trust receipts held by the bank.

Having in mind that the same plan of handling the finances of the cotton company and the payment of trust receipts obtained throughout the two years during which more than a million dollars of cotton was bought through and paid for to the plaintiff bank, all of which was clearly reflected in the books of the cotton company, it is hard to conceive how either the plaintiff bank or the other officers of the cotton company can be heard to say that they had no knowledge that the cotton company was handling the proceeds of cotton covered by trust receipts in the manner in which it did. Mr. Ivy, one of the vice presidents of plaintiff bank, when confronted with the fact that during the first year 92 acceptances with trust receipts attached, and during the second year 77 acceptances with trust receipts attached, were paid to the bank by the cotton company by checks drawn on the general checking account, and that in no single instance was the trust receipt literally complied with (that is, the "outbound document" returned to the bank in discharge of the trust receipt) frankly admitted that the bank was not concerned [page 376] as to how the acceptances were paid and the trust receipts discharged.

In view of the foregoing it is difficult to understand how any finding could be made that both the bank

and the other officers of the cotton company did not know and did not approve of the manner in which Sears was handling the cotton company's business. Furthermore, the officers of the cotton company were duty bound as officers and directors to know, and if they saw fit, to take no part whatsoever in the operation of the cotton company's affairs (and each testified that he took no active part), then they should not be permitted to complain that as a result of the operations the cotton company incurred liabilities for which it had no assets to cover. Furthermore, it must be reiterated that the fraud and deception which it is alleged Sears practised upon the cotton company by misrepresentation or concealment of facts or by failure to keep proper entries within its books, is not the basis upon which the loss sought to be recovered herein is predicated. The loss sued for herein is that resulting from liability incurred in favor of the plaintiff bank by the Cotton Company through the alleged wrongful conversion of the Cotton Company of 1091 bales of cotton in which the bank had an interest. While this liability was incurred, the Cotton Company sustained no loss by reason thereof, because it received the full benefits of the conversion of the property upon which the liability to the bank is predicated.

II.

The First Cause of Action in Plaintiff's Complaint as Amended Does Not State Facts Sufficient to Constitute a Cause of Action Against Defendant Bonding Company and the Trial Court Erred in Overruling Defendant's Demurrer Thereto and in Refusing to Find Judgment for the Defendants.

Assignments of Error Nos. 1 and 2.

The foregoing point is predicated upon the contention of plaintiff in error that plaintiff's first cause of action as pleaded shows affirmatively that the cotton company received and converted to its own use and benefit all of the property—to-wit, the 1091 bales of cotton, the liability for which by the Cotton Company to the bank, is the basis of the alleged loss upon which plaintiff seeks recovery. This matter has been argued at considerable length under a previous point in this brief and it is unnecessary to reiterate such statement. The trial court finds that the bank did sustain a loss by reason of the wrongful conversion of said 1091 bales of cotton. The conversion was made, by the arguments of the complaint, by the cotton company by its secretary while acting within the scope of his duties. The reasonable value of the cotton so converted was received by the Cotton Company and used for its own purposes. This is affirmatively pleaded in plaintiff's complaint [pages 46 and 49]. That the Cotton Company incurred a liability for the value of the property so converted to its own use, does not

amount to a "loss" under a fidelity bond against "loss." Mere liability is not sufficient.

It must be kept in mind that the theory of plaintiff's complaint and the whole basis of the learned trial judge's opinion is based upon the finding that the Cotton Company by and through the wrongful acts of its secretary, J. B. Sears, while acting for the Cotton Company and in the scope of his duties, wrongfully secured from the plaintiff bank 1091 warehouse receipts covering 1091 bales of cotton and wrongfully sold the cotton and converted the proceeds to the use of the Cotton Company's business. Neither the complaint nor the opinion of the trial judge predicates any loss to the Cotton Company by reason of the operating loss which was sustained by the Cotton Company during the second year of its operations, and no evidence was introduced to show the extent of any such operating loss. The trial court holds that the word "loss" in the bond sued upon is equivalent to the word "liability" where such liability arose out of the wrongful conversion by the Cotton Company through its secretary, of property in which the plaintiff bank had an interest—to-wit, the 1091 cotton tickets for which the plaintiff bank held trust receipts; and this notwithstanding the fact that it is admitted by all parties concerned that not one dollar of the proceeds from the collateral so converted was used by J. B. Sears personally or by any person, firm or corporation other than the Cotton Company itself.

To concede any such conclusion as contended for by the plaintiff bank is in effect to make the surety on

a fidelity bond a guarantor of every dollar of indebtedness fraudulently contracted by the risk, irrespective of whether the principal received the full benefit of the property so fraudulently obtained. Plaintiff in error respectfully submits that there is no ambiguity or uncertainty in the bond which would justify any such forced construction, and nowhere in the adjudicated cases or in text books has counsel for plaintiff in error been able to find any authority that makes or suggests any such possible construction, notwithstanding the fact that there are literally thousands of adjudicated cases involving bonds similar to the bond in question.

THE LAW.

The Bond Sued Upon Is Strictly One of Indemnity, That Is, One Against Loss and Not One Against Liability.

As found by the trial court [finding No. XI, page 140], judgment was obtained by the plaintiff bank against the Cotton Company covering the liability of the Cotton Company to the bank on account of acceptances and trust receipts. It is admitted that this liability has not been paid by the Cotton Company to the bank.

An Indemnitee Cannot Recover on an Indemnity Bond by Mere Liability Until Such Liability Has Been Paid.

See 31 C. J., page 439, and long list of cases cited therein.

The courts of California have interpreted the provisions of a bond against "loss which he may ever sustain" in a number of cases and have held that mere liability for loss is not sufficient. See

Fernandex v. Tormor, 121 Cal. 515;
Oakes v. Scheifferly, 74 Cal. 478.

To Constitute a Loss the Misapplication Must Be to the Use of Some Person Other Than the Insured.

In United States v. Butte, 107 U. S. 655, the court held that to constitute the offense of "misapplication,"

> "there must be a conversion to his own use or to the use of someone else of the moneys and funds of the association by the party charged."

In United States v. Breese, 173 Fed. 402, at page 406, the court said:

> "Wilful misapplication as described in the statute means a misapplication wilfully and unlawfully made by one or more of its officers of the moneys, funds or credits of the bank, and done with intent to injure the bank, and the funds so misapplied must be converted to the use of the officer or officers making such application, or to the use of some other person than the bank."

Frost on Guaranty Insurance, 2nd Edition, Sec. 477, defines "misapplication" and misappropriation" as being,

> "the wilful and wrongful use of money, property or effects entrusted to the party charged for some particular purpose and by him converted to the use of himself or to the use of others than the lawful owner."

In Rosentee v. American Surety Co., 91 N. J. L. 591, the court says:

> "The funds of a trust company are wrongfully misapplied by its teller when he converts it to his own use or benefit or to the use or benefit of someone other than the trust company with intent to injure and defraud the trust company."

The Bonding Company, as Insurer, Cannot Be Held Liable Under the Bond for Any Mere Errors of Judgment or Injudicious Exercise of Discretion on the Part of Sears, the Risk, in and About All of the Many Matters Wherein He Was Vested With Discretion, Either by Instructions or by Rules and Regulations of the Insured.

In the case of Monongehela Coal Co. v. F. & D. Co., 94 Fed. 732 (C. C. A. 5th Circuit) on the settlement of accounts the agent owed the employer; held, it was not proven that the employer "diverted from employer moneys"; and that the loss resulting from the carelessness or inattention to business might be the foundation of a just claim against the employee but it would impose no liability upon the bond.

In the case of Clark v. F. & D. Co., 73 Wash. 65, suit was brought upon a fidelity bond covering sales from consigned goods to one Miss Churchill. She relocated her business and lost money and was short in her remittances covering merchandise she had sold from consigned stock.

> "She appropriated the money to what she deemed to be the demands of the business for the mutual benefit of herself and consignor. She did not misappropriate it to her own use or make such a conversion of it as to subject her to a charge of larceny."

The court held that the bond protects the consignor against dishonesty of Miss Churchill and not against her lack of business knowledge.

The court at all times in considering this case must keep in mind that it is expressly pleaded that the proceeds from all of the property which it is held was, as to the bank, wrongfully converted, was deposited to the credit of the Cotton Company and used in its business.

Scope and Construction of Bond.

In construing contracts of insurance, the court must be guided by the rule suggested by the United States Supreme Court in the leading case of Guaranty Company of N. A. v. Mechanics Savings & Trust Co., 183 U. S., 407, where, speaking of strict interpretation of bonds, the court said:

> "But this rule cannot be availed of to refine away terms of a contract expressed with sufficient clearness to convey the principal meaning of the parties, and embodying requirements, compliance with which is made the condition of liability thereon."

As clearly pointed out by the cases cited in this brief, under the heading "Failure to comply with promissory warranty," a failure on the part of the insured to make at least a substantial compliance with the requirements of the bond does relieve the surety company, and the courts will not, under the doctrine of strict compliance, refine away the terms made in the contract of insurance.

It is the contention of defendant in error and seems to be the view adopted by the trial court that the parenthetical clause contained in the bond—to-wit, "including that for which the employer may be responsible to others" is explanatory of the word "loss;" and further that the word "loss" is synonymous with the word "liability." They conclude therefrom that the bond is in effect an agreement to reimburse the Cotton Company for any liability to the plaintiff bank arising out of the wrongful conversion by the Cotton Company to its own use of property in which the bank had a property interest.

Plaintiff in error urges that the parenthetical clause above referred to, being the usual and ordinary provision in fidelity bonds, is explanatory of the words "money, securities or other personal property," and not of the word "loss." It is designed to cover loss

sustained by the insured through the wrongful conversion by the risk of property of others held by the insured as bailee.

City Trust etc. Co. v. Lee, 204 Ill. 72.

In this case the provision of the bond was that it should cover "dishonesty or any act of fraud (amounting to larceny or embezzlement)". In interpreting this clause the court laid down the following rule of interpretation:

> "In the construction of written instruments a qualifying phrase is to be confined to the last antecedent unless there is something in the instrument which requires a different construction. This rule has been enforced in many cases."

Applying the above principle to the case at bar, it is apparent that the qualifying phrase "that for which the employer may be responsible to others" is by the rule of syntax explanatory of the words "property, etc.," and not the word "loss."

Fidelity guaranty insurance is a contract of indemnity and not one insuring against liability.

Joyce on Insurance, 2nd Ed., section 2766.

III.

There Is No Evidence to Support or Justify the Findings of the Trial Court as Set Forth in Findings No. VII That the Reasonable Value of the 1091 Bales of Cotton Sold and Disposed of by the Cotton Company and for Which the Plaintiff Bank Held Trust Receipts, Was at the Time the Same Were Sold and Disposed of, of the Reasonable Value of $60,594.62; or to Support Finding No. XXIV That the 455 Bales of Cotton Covered by Warehouse Receipts Delivered by Plaintiff Bank to the Cotton Company Prior to December 1st, 1920, and Not Returned to the Bank, Were at the Time They Were Sold of the Reasonable Value of $29,336.99.

Assignments of Error Nos. 11 & 26.

The loss for which the bonding company is held liable by the decision of the trial court is the amount in which the Cotton Company became liable to the plaintiff bank for having failed to return a certain number of warehouse receipts or the proceeds from the sale of the cotton represented thereby, as expressly provided in the trust receipts. Had the total proceeds from the sale of the cotton covered by trust receipts been returned to the plaintiff bank, the trust receipts would have been fully satisfied and discharged. It is respectfully submitted, therefore, that the amount of loss (liability) of the Cotton Company to the bank must be measured by the amount realized by the Cotton Company from the sale of the particular cotton, or in any event, the reasonable market value of such cotton at the time it was sold and disposed of. The undisputed evidence shows that every bale of

the cotton in question was sold by the Cotton Company at a price considerably less than the original purchase price, by reason of the steady decline in the cotton market. The record shows [page 436] that during the second year, on the average, every bale sold for $12.00 less than the cost. The Cotton Company was bound by the trust receipts to return either the warehouse receipts or the proceeds from the sale of the cotton, and if an amount less than the original purchase price was received when the cotton was sold, the trust receipts would have been fully discharged by a return of such sale price. There is no contention that any of the cotton in question was not sold at the then reasonable market value.

The trial court, however, fixes the loss (liability of the Cotton Company to the bank for unreturned warehouse receipts) in an amount equal to the original cost price of the cotton to the Cotton Company. It is conceded that the Cotton Company owed the plaintiff bank an amount equal to the original cost price of the cotton, because the bank had paid the purchase price drafts for the Cotton Company, that is, advanced the money to pay for the cotton, but such liability for moneys so borrowed from the bank is not the liability upon which the plaintiff in its complaint, or the trial court in its opinion, fixes the loss. The trial court expressly holds in its opinion [page 180] that the loss for which the bonding company is liable is an amount equal to the liability of the Cotton Company to the bank for the misapplication of the proceeds from the sale of the cotton in question by the Cotton Company. The measure of damage for failure to return the "outbound documents" as expressly provided in the trust receipts, must be measured by the sale price of the cotton and not by the original purchase price.

IV.

The Cotton Company During the Latter Part of 1920 Became a Corporation Sole—To-wit, J. B. Sears, and Thereafter J. B. Sears, the "Risk" Named in the Bond, Was in Complete Ownership and Control of the Cotton Company. That on and After the Date When Such Complete Ownership and Control Was Obtained by J. B. Sears the Cotton Company—To-wit, J. B. Sears, Had No Right of Action to Recover for Any Loss Sustained by the Wrongful Acts of J. B. Sears, Whether Committed Prior to or Subsequent to the Date on Which the Ownership and Control of the Cotton Company Was Acquired by Sears. For That Reason the Trial Court Erred in Finding Judgment Against Defendant and in Refusing to Grant Defendant's Motion for Judgment for Defendant. In View of the Finding of Fact That the Cotton Company Became a Corporation Sole—To-wit, J. B. Sears, on December 1st, 1920, the Trial Court Erred in Its Conclusions of Law That the Plaintiff (Assignee for Collection of the Cotton Company) Was Entitled to Judgment for Any Loss Resulting From the Wrongful Acts of J. B. Sears.

Assignments of Error Nos. 2, 25, 27, 28, 30.

Facts.

The trial court in its findings of fact [finding No. 21, pages 148-151], finds that prior to December 1st,

1920, the Cotton Company was merely a medium through which T. J. West was conducting his cotton brokerage business and was in fact a corporation sole —to-wit, T. J. West. During this period of time Sears was merely an employee and that relationship necessary in all cases of fidelity insurance, to-wit, "principal" and "risk" existed. The court further finds that on December 1st, 1920, the complete ownership and control of the Cotton Company passed from the principal, T. J. West, to the risk, J. B. Sears, and that after December 1st, 1920, the Cotton Company was a corporation sole—to-wit, J. B. Sears. This situation continued and at the time of the death of J. B. Sears on May 3, 1921, he was still the owner of the Cotton Company and so far as the record shows, the ownership of the Cotton Company passed to and remains an asset of his estate. Thereafter—to-wit, on the first day of September, 1921, the Cotton Company assigned for collection to the plaintiff bank its cause of action, if any, existing against the bonding company on the bond.

As clearly expressed by the learned trial judge in his opinion [page 174], "This action must be considered having in view only the obligations created by the bonding company toward the cotton company, and strictly as though there had been no assignment." This for the reason that the plaintiff bank is a mere assignee for collection and as such assignee could have no greater rights than the cotton company—to-wit, J. B. Sears, a corporation sole. Therefore, in the argument upon this point we will disregard the assignment

and consider solely the question whether or not the cotton company had any right of action against the bonding company at the time this action was filed for any loss that may have been sustained by reason of any wrongful acts of J. B. Sears.

After Sears' death the cotton company filed its proof of loss with the bonding company for an alleged loss aggregating in excess of $60,000.00 resulting from alleged wrongful acts done by J. B. Sears while acting as secretary of the cotton company. If such a valid claim against the bonding company for recovery of the loss existed under the bond, such claim constituted an asset of the cotton company and existed prior to Sears' death as well as subsequent to his death, although it could not ripen into a cause of action until a proof of claim had been duly filed with the bonding company. The fact that Sears died does not affect the situation as to the right of the cotton company to recover. It was merely an unfortunate incident in the matter. The corporation for all legal purposes was just as much a corporation sole—to-wit, the estate of J. B. Sears, after his death as it was a corporation sole immediately prior to his death. Admittedly during Sears' life time the cotton company—to-wit, J. B. Sears, could not have maintained any action at law to recover from the bonding company any loss resulting from any fraud, dishonesty, forgery, embezzlement, wrongful abstraction or wilful misappliacation by J. B. Sears of the cotton company's property, or of any property in which the cotton company was interested for the very self-evident reason that

to permit such recovery would be to permit J. B. Sears to benefit directly from his own wrong. Any sum recovered after December 1st, 1920, by the cotton company from the bonding company by reason of loss resulting from the wrongful acts of J. B. Sears would have been solely for the benefit and use of J. B. Sears or of his estate, he being the corporation sole.

The trial court very properly held that any loss resulting from the wrongful acts of J. B. Sears after he became the corporation sole could not be recovered from the bonding company because from that date on the very fundamental relationship of "principal" and "risk" was destroyed—that is, the relationship of employer and employee ceased to exist; and for the further fundamental reason that Sears, doing business through the cotton company, could not recover any loss resulting from his own wrongful acts. It is respectfully submitted that the trial court erred in its conclusions of law from the fact found that the cotton company became and was a corporation sole —to-wit, J. B. Sears, on and after December 1st, 1920, that the cotton company (that is, J. B. Sears), could thereafter recover for any loss that may have been sustained by the cotton company prior to December 1st, 1920, by reason of the wrongful acts of J. B. Sears. The rule that a man cannot recover damages resulting from his own wrongful acts would work effectively against recovery by the cotton company (that is, J. B. Sears), whether such loss was incurred by reason of wrongful acts of J. B. Sears performed prior to December 1st, 1920, or subsequent thereto.

It is respectfully submitted that when J. B. Sears purchased all of the stock of the cotton company from West he acquired thereby the ownership of any claim which West or the said cotton company had against the bonding company arising from the wrongful acts of J. B. Sears, and that the acquisition of ownership by Sears of such claim based upon his own wrongful acts, terminated all liability on such claim, and that Sears, doing business as the cotton company, could not have enforced any such claim against the bonding company. Such claim, if any existed in favor of the cotton company, a corporation sole—to-wit, T. J. West, ceased to exist when the cotton company became a corporation sole—to-wit, J. B. Sears, and said claim was terminated and extinguished and thereafter there was no claim in existence which could have been assigned to the plaintiff bank herein. No person has any enforcible claim for loss resulting from his own wrongful acts and, therefore, such person cannot by assignment give any rights to an assignee.

THE LAW.

The Liability of an Insurer Is Never Greater Than the Liability of the Risk to the Insured. The Merging of the Risk (J. B. Sears) and the Insured (Cotton Company) in the Same Person Extinguished the Claim and Released the Liability of the Insurer.

The Sale by West, a Corporation, to Sears, a Corporation Sole (the Risk), Released Sears as Principal on the Bond—Which Release Discharged the Surety.

"The policy of fidelity insurance being essentially one of indemnity, to enforce a claim thereunder against the insurer for the benefit of an insured, who had no concurrent existing legal claim against the 'risk' therefor, would be to change the nature of the agreement from one of indemnity to that of a wagering contract. To entitle the insured to recover under a fidelity insurance policy, it is in every instance incumbent upon him to show some invasion of his legal rights on the part of the 'risk' which in itself constituted, at the time such recovery is sought, a valid enforceable claim against the 'risk' in favor of the insured." Frost on Guaranty Insurance, Second Edition, page 69.

Independent School District v. Hubbard, 110 Ia. 58; 81 N. W. 241;

Volume I, Cooley's Briefs on Insurance, pp. 236-237.

The Supreme Court of North Carolina in a recent case, Blades v. Dewey, 48 S. E. 26, stated the general

principle governing contracts of compensated suretyship as follows

> "Every contract of suretyship is based upon some contract made or obligation assumed by the principal obligor, and the liability is measured by the obligation of the principal."
>
> Electric Appliance Co. v. U. S. Fid. & Guar. Co., 110 Wis. 343; 85 N. W. 648;
>
> Am. Sur. Co. v. U. S., 28 Sou. Rep. 664;
>
> Iowa Tillooet Gold Mining Co. v. Bliss, 144 Fed. 446.

Frost in his treatise on Guaranty Insurance (page 352) says:

> "In general there can be no recovery had by the insured against the insurer under a policy unless there is in existence at the same time a valid and enforceable claim against the 'risk' for the same cause in favor of the insured. The reason of this is obvious. Fidelity insurance is a contract of indemnity only, and further it is an indemnity against loss arising from acts of the 'risk' in breach of his own contract obligations to the insured. Thus an unquestioned limitation on the insurer's liability is that the claim shall be a valid and enforceable one against the 'risk' in favor of the insured. Were this not so, the valued right of subrogation would be worthless to the insurer, as he could not in any event recover of the 'risk' the amount he had paid to the insured on an invalid and unenforceable claim." * * *
>
> [Page 353]: "As it is a sound principle of law that the obligation of the insurer to the insured can never be greater than the liability of the 'risk'

to the insured, so it may be said that the law implies from policies of guaranty insurance the condition, irrespective of express conditions in the policy to that effect, that the liability of the 'risk' to the insured after a loss has occurred, for which the insurer is liable to the insured under the policy, shall not be changed in any material respect. This on the principle that the inchoate right of subrogation belonging to the insurer under such circumstances is a valuable right, and that for this reason no material change in the status of the 'risk' with respect to the latter's liability to the insured, as it existed at the time the loss occurred, will be permitted."

Again on page 402 the learned author says further:

"Discharge of Insurer's Liability by Formal Release of the 'Risk's' Liability Running From the Insured to Such 'Risk.' Fidelity insurance is preeminently a contract of indemnity. Therefore there can be no legal liability incurred by the insurer under a policy of fidelity insurance, unless there exists at the same time a liability at least as coextensive on the part of the 'risk' to the insured. Furthermore it follows that when there is a voluntary release on the part of the insured of the 'risk's' liability to it, such release has the effect in law of releasing the insurer from liability—if such exists—to the insured on account of the matter covered by the release of the 'risk' by the insured. A similar result is arrived at whenever the liability of the 'risk' to the insured is satisfied by payment of the debt represented by such liability. In other words the principal obligation—that of the 'risk' to the insured—being satisfied, the incidental obligation—that of the

insurer to the insured—is likewise discharged." See Perpetual Bldg. & Loan Assn. v. U. S. Fid. & Guar. Co., 118 Ia. 729; 92 N. W. 686.

"It is doubtless true that even where the insured secretly receives from the 'risk' the full amount of the insurer's liability on account of a loss covered by the policy, he will be held in law, under a well-recognized rule of subrogation, to hold such payment in trust for the insurer, as the law will not permit him to profit by a recovery for the same debt against both the insurer and the 'risk'. See Am. Sur. Co. v. Lawrenceville Cem. Co., 110 Fed. 717; C., St. L. & N. O. Ry. Co. v. Pullman, Sou. Car. Co., 139 U. S. 79."

It is respectfully submitted that under the general principles of law in relation to suretyship above announced no liability on the part of the bonding company exists, because no valid and enforceable claim existed in favor of the cotton company, a corporation sole—to-wit, J. B. Sears (the insured) against J. B. Sears (the risk) after December 1st, 1920, and at the time of the attempted assignment by the cotton company to the plaintiff bank no claim in fact existed.

The finding of the trial court that the cotton company became a corporation sole—to-wit, J. B. Sears, was proper. In a recent case decided by the Supreme Court of California, Wenban Estate v. Hulette, 67 Cal. Dec. 493; 227 Pac. 723, the court held that where a corporation is but the instrumentality through which an individual transacts his business, the corporation will be bound by the acts of the sole stockholder just as it would be bound if the corporation did not exist.

This decision is in keeping with prior California decisions and also in line with decisions of this court. See Miller and Lux v. Ricker, 146 Fed. 574, affirmed by the United States Supreme Court in 218 U. S. 258. In that case the court held that where suit is brought by a riparian owner to enjoin another riparian owner from diverting the water, and the latter, pending the suit, converts his rights to a corporation organized for that purpose and owns all its stock, such corporation is bound, although not a party to the suit, for the reason that the corporation was merely the person under another name.

See also case, Mills v. The Richmond Co., 63 Cal. App. 594, in which the court held that when an individual conducts his business under a corporate name owning all of the stock of the corporation, except a few qualifying shares, the difference between the individual and corporate entities will be disregarded if necessary to work out equitable ends.

The defendant bonding company (insurer) insured the cotton company (insured) against loss that might result from wrongful acts of its agents, Sears (the risk). All contracts of guaranty insurance imply some contractual relationship or obligation between the insured and the risk. As stated by Frost in his "Treatise on Guaranty Insurance" (Second Edition, p. 45):

> "A fact that may be stated as a general principle governing all branches of guaranty insurance is that every contract of compensated suretyship is based upon some contract made or obligation assumed by the 'risk' and the liability of

the compensated surety thereunder is measured in all cases by the obligation of the 'risk' to the party for whose benefit such contract of compensated suretyship was entered into. The obligation of the insurer to the insured can never be greater than the liability of the 'risk' to the insured."

Likewise, it is fundamental that the insured in all cases must possess what is termed an insurable interest in the policy.

As stated again by Frost, the reason for the above rule is as follows:

"The underlying reasons which render it necessary that the insured shall have an insurable interest in all fidelity insurance policies, where liability thereunder is sought to be enforced for his benefit, are mainly three in number.

First. It is contrary to the spirit of the law, which always favors legitimate business, that it should sanction speculation on the honesty or faithfulness of one's fellow-men.

Secondly. It is opposed to the public policy in that it would permit a party to enter into a contract wherein it would be to his pecuniary interest to induce dishonesty or unfaithfulness on the part of the 'risk,' which would operate to his advantage and to another's pecuniary disadvantage. In other words, under such circumstances, dishonesty and unfaithfulness would be at a premium, and honesty and faithfulness in public or private duty the last thing sought for.

Thirdly. In view of the fact that the policy is universally executed with reference to the in-

dependent contractual or official obligations of the 'risk' to the insured, it is in harmony with the policy of the law, clearly recognized in the case of contracts identical in purpose of that entered into between the insured and the insurer in fidelity insurance, to insist that the right to enforce such contracts, as between the insured and insurer, should not be more extensive than the right to the insured to enforce the contemporaneous contractual or official obligation of the 'risk' to himself."

On this point, Mr. Cooley in his "Briefs on Insurance," page 236, says:

"The general principle emphasized in all cases, involving the extent of liability under guaranty and indemnity contracts, that the contracts are strictly contracts of indemnity, and that the measure of liability is the extent of actual loss, is strictly in accord with the principle that insurable interest is necessary, and it is consonant also with the general rule prevailing in fire and marine policies, that the extent of recovery is limited to the extent of interest. Since a guarantor cannot be held liable on his guaranty except to the extent that the original debtor or risk is liable on his contract, it is evident that under a contract of guaranty insurance the extent of insurable interest is measured by the interest in the risk."

Again Frost, on page 346, says:

"Implied Exceptions. The law implies, irrespective of express provision therefor made in the policy, certain conditions limiting the liability of the insurer to the insured under the terms

thereof. These implied exceptions to liability may be enumerated as follows:

* * * * * * * * * *

(B) From the very nature of a policy of fidelity insurance, which is at all times a contract of indemnity, it follows as one of the implied conditions of the policy that the insured should continue throughout the life of the policy to have an insurable interest therein. The recognition of such an implied condition is sometimes termed the 'doctrine of continuity of interest'."

* * * * * * * * * *

(D) One of the implied conditions of all policies of fidelity insurance is that the 'risk' shall continue to occupy the position in the employ of the insured designated in the proposal or application for the policy. Unless the policy expressly provides for changes in such employment, as, for example, expressly authorizing employment in more than one position, or changes from one position to another, there can be no recovery had by the insured from the insurer on account of defaults of the 'risk' occurring while performing duties of a position materially different from that designated in such proposal or application. The reason which induces the courts to imply such a condition as the foregoing, is that fidelity insurance companies write policies for certain designated premiums, which vary in amount according to the nature and extent of the risk incurred. If, for example, the insured asks the insurer to write a policy on a person employed as a bookkeeper in a bank, the insurer might be willing to do this at a very low premium, owing to the small chance of its ever being required to

make good any losses occasioned by such person's dishonesty while occupying the position of bookkeeper for the insured. However, if it lay within the power of the insured to change the employment at will of such person, and immediately after issuing the policy he should appoint him cashier instead of bookkeeper, it would amount to little less than a fraud upon the insurer to hold the latter liable for his acts and increased responsibilities not in contemplation of both parties at the time the policy was issued.

(E) Another implied condition of fidelity insurance policies is that there shall be no change in the composition of the insured or in the personality of the 'risk' during the life of the policy. Fidelity insurance is a personal contract, and there should be no alteration permitted either as to parties insured, or as to the 'risk' without the consent of the insurer."

In the case of Farmers and Merchants State Bank of Verdon v. United States Fidelity & Guaranty Company, decided by the Supreme Court of South Dakota and reported in 36 L. R. A., (New Series) 1152, suit was brought upon a fidelity bond guaranteeing the insured against loss resulting from the wrongful acts of the risk who was employed as assistant cashier. The bond, however, provided that the employee could perform other duties than those belonging to the position mentioned in the bond without any notice of such change being given to the bonding company. At the time the bond was written, the employee owned only one share of stock but later, and during the continuance of the bond, he became cashier and also ac-

quired 52% of the stock. Notice of this fact was not given to the bonding company. It was urged that the change of relationship of the employee did not affect the liability of the bonding company because it did not change the employee's duties and responsibilities beyond those provided for in the bond. The court, however, held the bonding company not liable in the following words:

> "But there was a change in the employee's status in this case, not considered by the court in the Georgia decision. In that case the employee presumably continued to occupy a subordinate position, subject to the control and supervision of the corporation, acting through its board of directors. When the policy in suit was issued, James H. Carroll was the owner of only five shares of the plaintiff's capital stock; its entire capital being $10,000. On October 10, 1903, before the alleged fraudulent acts were committed, he became the owner of 51 shares previously owned by his brother, constituting a majority of the stock, with power to select a new board of directors. After that date, he was in position to absolutely control the affairs of the bank. While in one sense he continued to be an employee of the corporation, he no longer was subject to the restraining influence of efficient supervision. He was acting as a director. Theoretically, his conduct as cashier was subject to the supervision of the other directors, so long as he allowed them to remain directors and officers of the corporation; but they were holding their positions during the pleasure of the person who owned a majority of the shares of the capital stock, and, as dis-

closed by the evidence, were, in fact, giving no personal attention to the management of the bank. It may be that their negligence in this regard would not of itself relieve the defendant of liability. On that phase of the case, no opinion is expressed. The precise question under discussion is the effect of the fact that Carroll became the owner of a majority of the capital stock, practically becoming the master of the corporaton, and ceasing to be one of its servants. Clearly here was a situation not contemplated by the parties when the policy was issued, and not embraced by any fair and reasonable construction of its terms. In absence of convincing evidence, it would be unreasonable to assume that the defendant would insure the conduct of any man thus situated. An undertaking insuring a person against his own dishonesty would be, to say the least, a novel and unusual contract. *Had the plaintiff been a natural person engaged in the banking business, and this employee purchased the business or a controlling interest therein, certainly no one would contend he could maintain this action for his own benefit or that of the depositors* (Italics ours.) The object of the undertaking was to insure an employer against the fraudulent acts of an employee, not to insure an employer against his own fraudulent acts. When the person whose conduct is insured ceases to be an employee, within any fair and reasonable interpretation of the term used in the policy, the insurer's liability should cease, unless he has notice of the change. So we conclude that the facts disclosed by the records on this appeal constitute a complete defense, and that the judgment and order appealed from should be reversed."

Learned counsel for plaintiff pointed out correctly to the trial court that this decision was later over-ruled by the South Dakota Supreme court in the case of Bank of Willow Lakes v. Syverson, 43 South Dakota 295, 178 N. W. 989. A careful reading, however, of this later South Dakota decision does not in any way repudiate the rule annunciated in the earlier case that a substantial change of relationship between the employer and employee relieves the surety company from liability, but rather construes the change of relationship as being one contemplated by the bond.

After West sold his stock to Sears, the latter was the only party financially interested in the Cotton Company and, as found by the court became the corporation sole.

> "Although the doctrine that a corporation is a legal entity and person in the law distinct from the members who compose it will always be recognized and given effect, both in law and in equity, in cases which are within its reason and when there is no controlling reason against it, and although in some cases it seems to have been given effect contrary to reason, it is clear that a corporation is in fact a collection of individuals who, in the case of modern private corporations, really own its property and carry on the corporate business, through the corporation and its officers and agents, for their own profit or benefit, and that the idea of the corporation as a legal entity or person apart from its members is a mere fiction of the law introduced for convenience in conducting the business in this privileged way; *and it is*

now well settled, as a general doctrine, that, when this fiction is urged to an intent not within its reason and purpose, it should be disregarded and the corporation considered as an aggregation of persons, both in equity and at law."

14 Corpus Juris, 59, Sec. 20.

In re *Rieger,* 157 Fed. 609.

In that case a partnership in the commission business buying and selling merchandise, acquired 99% of the stock of a corporation. The remaining shares were held by relatives of one of the partners. The partners held about equal amounts of the stock. It was held that the corporation was merely an agent of the partnership.

On page 614, the court say:

"In Interstate Telegraph Co. v. Baltimore & Ohio Telegraph Co. (C. C.) 51 Fed. 49, affirmed in 54 Fed. 50, it appears that the railroad company caused the telegraph company to be incorporated, became the sole owner of its stock, selected its own officers and employes as officers of the new company, and represented such company to have authority to contract with reference to its whole railway telegraph system. It was held that the railroad company was not only the actual owner of the telegraph company, but that the latter company was a mere department, or bureau, of the railroad company, created and maintained for the railroad company's benefit as an agent to make contracts. It follows as a corollary that, had the railroad company become insolvent while the telegraph company was in existence, the property in the possession of the

telegraph company, notwithstanding its corporate entity, would, if necessary, have been treated as property of the railroad company. The Supreme court of Ohio has repeatedly ignored the fiction of legal corporate entity when used as a shield for fraudulent or other illegal acts. The rule is clearly stated in Bank v. Trebein Co., 59 Ohio St. 316, 52 N. E. 834, as follows:

" 'In contemplation of law, a corporation is a legal entity, an ideal person, separate from the real persons who compose it. This fiction, however, is limited to the uses and purposes for which it was adopted—convenience in the tranaction of business, and in suing and being sued in its corporate name, and the continuance of its rights and liabilities, unaffected by changes in its corporate members. But the fiction can not be abused. A corporation *cannot* be formed for the purpose of accomplishing a fraud or other illegal act *under the disguise of the fiction;* and, *when this is made to appear, the fiction will be disregarded by the courts, and the acts of the real parties dealt with as though no such corporation has been formed,* on the ground that fraud vitiates everything into which it enters, including the most solemn acts of men. * * * The good faith of the parties to such a transaction must be determined by its legal effect on the rights of others. If its legal effect works a fraud on their rights, the finding of the court that the parties acted in good faith is simply an erroneous conclusion of law from the facts'."

(Citing many cases.)

Meily Co. v. London & Lacashire Fire Ins. Co., 148 Fed. 683. (Circuit Court of Appeals, Third Circuit.)

The syllabus is:

"Evidence which warrants a finding that the property of a corporation plaintiff was wilfully burned by its president, who had full control of its affairs and was the owner of practically all of its stock, the remainder being owned by members of his family; that the business was on the decline, the lease about to expire, and the property over-insured; and that the over-valuation was participated in by other members of the family —is sufficient to charge the corporation with the act of incediarism, and to constitute a defense to an action to recover the insurance."

V.

The Court Erred in its Finding of Fact That the Control of the Cotton Company Did Not Pass From West to Sears Until December 1st, 1920.

Assignments of Error Nos. 25 and 30.

There was considerable testimony as to the date when the actual control of the cotton company passed from West to Sears and as to the exact date when the stock certificates in favor of West were cancelled and new certificates issued to Sears. The trial court first fixed the date as of September 1st, 1920, pointing out in its opinion (page 176) that,

"Considering next the evidence as to the transfer of West's stock to Sears, and its effect upon

the liability of the defendant: Remembering that, as has been already observed, the questions here are to be considered as though the cotton company was the plaintiff, the evidence of West, who was the owner of the cotton company, as to when he transferred his interest to Sears, must be allowed full weight. A different consideration might arise, were this an action by a creditor to enforce a stockholder's liability for corporate debts against West. If West, being the company, declares to the defendant: 'This corporation went under the ownership of Sears at a certain date, and Sears then came into full and complete control' he would announce such a change in the conditions as to make the hazard different from that existing when the insurer made its bond. Furthermore, public policy would not favor the enforcement of a contract which would permit an individual to indemnify himself against his own misconduct."

"West testified that he made the sale of his stock to Sears during the latter part of August. He contended also that it was a part of the agreement of sale that the transfer should be considered as relating back to the month of May, 1920, but I think, the evidence on the subject being considered altogether, the best conclusion that can be made is to fix the date of the transfer at the first of September, 1920. We then must consider that from that date West owned no further interest in the business, and that Sears then became the sole proprietor of it. Therefore, if there exists any liability on the part of the insurer under the bond sued upon, it must be such only as accrued prior to the first of September, 1920."

Later upon further consideration the court changed the date to December 1st, 1920, upon the theory that that was more nearly the date when the transaction between West and Sears was concluded, it being admitted that the promissory note given by Sears to West in payment for the stock bears date December 1st, 1920. All of the testimony on the point as to the transfer of control and ownership is as follows:

Testimony of T. J. West:

"Q. And when did you sell the stock to Mr. Sears?
"A. In the latter part of August, 1922.
"Q. And what, if anything, did you then do with the original certificates issued to you?
"A. Sent them in to the secretary to be transferred." [Tr. p. 380.]

"Q. Now you said it was along about August that you sold out to him?
"A. In the latter part of August, 1920." [Tr. p. 381.]

"At the time I sold my stock to Sears about the last of August, 1920, there was one share of stock left in my name. We had no particular arrangement about it; in fact, nothing was said. Sears gave me a note in payment for the stock which I sold to him. The note didn't come along, however, until in December, 1920. The reason I disposed of my stock was because I had more than I could attend to and Mr. Sears and Mr. McDevitt wished to continue the business, and I gave them a chance to work it out. The prospects were bright and they had a good start. [Tr. pp. 382-383.]

"For the 946 shares of stock I received the note of T. W. McDevitt subsequent to December 1st, 1920. The note was secured by pledge of the 496 shares of stock. I did not receive the pledged stock at the time I received the note. I got the stock before the note was sent to me." [Tr. p. 388]. The 496 shares of stock were sent through the mail and the note came later. [Tr. p. 388.]

West testified [Tr. pp. 389-390] that between August 25th and September 9th he went to Hartke, who was the secretary of the cotton company, to have the stock transferred and that the transfer was actually made some date between the first and 9th of September 1920 [Tr. p. 389]; that he requested the certificates to be dated back to May 24th. West further testified [Tr. p. 393] that it was his intention to liquidate and close up the cotton company's business at the end of the first year, but that Sears begged him not to do so, and that he then agreed to accept the note of either Sears or McDevitt and sell the stock to Sears, and this discussion took place in the latter part of August, 1920 [Tr. p. 394]; that he told Sears to send the note to him at Calexico and that he, West, then returned to Calexico and secured the certificates standing in his name and sent them in for transfer, and that the new certificates made out in the name of J. B. Sears were sent down to him during the first part of September [Tr. p. 395], and about two weeks after the original certificates were sent in for cancellation; and that he made the sale on the basis of ending of business, April 30th [Tr. p. 395]; and that

he, West, wanted to be relieved of any responsibility for the incoming season's business [Tr. p. 396]; that Mr. Hartke was secretary at the time he sold out to Sears [Tr. p. 396.]

Mr. Norsworthy, the cotton company's bookkeeper, testified that he personally cancelled the old certificates and made out the new certificates to Mr. Sears, but that they were not made out on the date they bear—to-wit, May 24th [Tr. p. 423]; that the actual date of issuance was originally written upon the stocks and certificate and later erased and dated back to May 24th.

Mr. Hartke, who signed as secretary the new certificates issued to Sears, testified [Tr. p. 459] that he had a conversation with West in connection with the transfer of the stock, and that this conversation took place about the 1st day of December, 1920, and that such conversation and the issuance of the stock certificates was some time after December 1st, 1920, and that he, Hartke, was not secretary of the cotton company at the time he signed the certificates, but inasmuch he was secretary on May 24th, the date the certificates bear, he executed them as secretary [Tr. p. 460]; that the date originally entered upon the certificates was December 1st, 1920. [Tr. p. 462].

In addition to the foregoing, the original stock certificates and stock certificate stubs were carefully examined by Milton Carlson, well known handwriting expert, and he testified that the date originally entered upon the stock certificates and upon the stock

certificate stubs and which date was later erased, was November 17, 1920. [See Stipulation p. 478]. Even though the exact date of the transfer of the stock certificates did not occur, and all the details of the purchase of the stock, were not completed, until December 1st, 1920, it is nevertheless respectfully submitted that the control of the cotton company, so far as actual operations of the cotton company's business was concerned, occurred before the cotton company began its second season's operations—to-wit, prior to November 17, 1920. All of the wrongful acts upon which loss is predicated occurred after November 17, 1920. From the foregoing testimony it will be clearly observed that the deal between Sears and West was made on the basis of Sears' taking over the company as of May, 1920, the end of the first cotton season, and that West's intention was that he would not continue the business during the second season; and that he turned over the complete management and control to Sears prior to the time when the second season began. This situation resulted in there being in fact no relationship of employee and employer during the time the alleged losses were sustained and under the law as announced under point V (supra) the destruction of such relationship released the bonding company from all liability for any acts thereafter performed by the "risk."

VI.

There Was a Breach by the Cotton Company of the Promissory Warranties Made to the Bonding Company and Given as Consideration for the Execution of the Bond, and of the Provisions of the Bond, in That the Cotton Company's Books, Accounts, Stocks and Securities Were Not Inspected and Audited by T. J. West, as Warranted.

Assignments of Error Nos. 31, 27, 28, 23, 20 and 2.

FACTS

At the time the bond sued upon was issued the cotton company executed and delivered as part of the consideration for the issuance of the bond answers to certain questions, and expressly agreed as follows:

"It is agreed that the above answers are warranties and constitute the basis of and form a part of the consideration of the bond executed or about to be executed by the Maryland Casualty Company in favor of the undersigned upon the person above named, and also all continuations or renewals thereof or substitutions therefor, until superseded by other written answers similarly furnished to and accepted by the said Company." [Tr. p. 204].

The bond itself further provides:

"That all statements which the Employer has furnished to the Company concerning the Employee or his duties or accounts are warranted by the Employer to be true;"

One of the warranties made, being paragraph 12 [Tr. p. 202] is as follows:

"12 (a). At what intervals will applicant's books, accounts, stock and securities be inspected and audited and verified with funds on hand or in bank? a. Books checked at least once in every ..... month. Books checked up each month.

"(b). At what intervals and in what manner will outstanding accounts, as shown by applicant's books or reports, be verified? b. We have no such accounts.

"(c). If salesman or collector, how often do you bill the trade direct? c. .....

"(d). By whom will above inspections and audits be made? d. T. J. West Treasurer * * * official capacity."

There is no dispute in the testimony as to what T. J. West did in the way of checking up or examining the books. With the exception of a general statement by the witness, Norsworthy, West's testimony was the only evidence introduced on that question. West testified as follows:

"Q. Did you ever make an examination of his bank account—cash in the bank?

"A. No; only checked the accounts by the statements rendered by the bookkeeper.

"Q. Now what do you mean by that, Just explain to the court so that the court may know what you did in that connection.

"A. There was a statement rendered every month by the bookkeeper which would be sent to all of the officers—or those interested—and outside of going over the purchase and sales accounts, the books were

mere routine; I simply looked at them, without considering them of any particular importance." [Tr. p. 334.]

"I examined those statements to see what the bank account was—that is all—just to see how it stood. I knew that Mr. Sears died on or about the 1st day of May, 1921. I should say it was about the latter part of March, or, well, sometime in March that I had my first conference with him at which I made the examinations about which I have already testified." [Tr. p. 334.]

"Q. Now, what books of the company, if any, did you ever examine?

"A. I only was interested in the purchase and sales account of the cotton.

"Q. Well, what particular book did you ever examine?

"A. The cotton account and the acceptance account." [Tr. p. 337]

"Q. Well, did you examine this acceptance book during the second fiscal year beginning, we will say, September 15, 1920, and thereafter?

"A. Not to the same extent and intensiveness as I did the first year, but enough to see whether they were making money enough to pay me. I was interested to see that, they were making money enough to pay me for my stock that I sold them, and I kept track of it on that basis.

"Q. Well, who pay you?

"A. Mr. Sears." [Tr. p. 337]

"Q. Now take during the second year, beginning in August or September, 1920, on until Mr. Sears death, and tell the court in detail just what the nature of your examination was of those three books.

"A. Well, we didn't do any detailed checking, but he would show by the cotton bought and the cotton sold how many bales there would be unsold, and that he had it hedged, and that he would show by his cash account and acceptance account the number of bales on hand and that it corresponded to the acceptances in the bank. That is all the details we would go into.

"Q. Did you personally check the three books you have in your hand?

"A. Not in detail at any time, because they were always in balance. Every night the books would show how many bales of cotton had been bought and sold, and the balance on hand, and the acceptances in the bank would agree with it. If there was any difference I would want to know if they were hedged.

"Q. *Well, did you at any time during the second year of the company's operations make any independent check for yourself of the books?*

"A. *No, nor the first year either.*

"Q. And did you rely on the statements of Mr. Sears or upon your own investigations? (Italics ours.)

"A. I relied more or less on his statements, and I could see the books for myself—the totals." [Tr. pp. 337-338]

"A. The bundle of tickets which Mr. Sears showed me were 500. I did not at any time personally check and count the tickets. I did not at any time go to the Citizens National Bank and check the indebtedness of the Cotton Company to the bank, but took the statements as made in the office. I did not have any of these statements which were prepared monthly and mailed to me.

"Q. *Did you ever check or make any audit or check of the books to ascertain whether or not the*

statements that were being sent to you each month were correct?

"A. *No. I never would have questioned any statements sent out by Sears.* (Italics ours.)

"Q. And he, so far as you know, did have on hand at the particular date when he exhibited the tickets to you which he took from the safe, the number of tickets called for by the bought and sold cotton account?

"A. Yes, sir. I didn't count them, but it looked to be right.

"Q. Did you ever examine this ledger account wherein there appears to be an entry of cotton bought and cotton sold?

"A. No, not that I remember." [Tr. pp. 339-340.]

"I did not know that the Cotton Company, after it sold the cotton covered by the trust receipts was selling the cotton and putting the outbound documents—that is the drafts drawn on the purchaser of the cotton together with the bill of lading therefor in the checking account of the Citizens National Bank. I thought Sears was taking up acceptances with the proceeds from the sale of the cotton covered by trust receipts. I did not know where he was depositing the money received from the sale of the cotton. I never made any check to ascertain how he was handling the monies realized from the sale of cotton.

"Q. Did you ever go over, while acting as treasurer, and investigate any of the books of the Citizens National Bank or any of the acceptances or records there in the bank?

"A. No; I never went over any records.

"Q. Did you ever look at the check book of the Cotton Company?

"A. No, I never saw a check book.

"Mr. Cosgrove: Do you mean by that check stubs?

"Mr. Parke: Yes, the check stub book.

"Q. Did you ever inquire of Mr. Sears how he was paying the acceptances—that is, in what manner he was paying them?

"A. No, I did not." [Tr. pp. 341-342.]

"I cannot say whether we had a special expense account in the bank in this particular instance or not. Mr. Sears paid the acceptances during the first year of the Company's business by checks drawn on the company's general checking account. I do not know whether he paid operating expenses of the Cotton Company during the first year out of the general checking account or not, as I never checked the books to ascertain that fact." * * *

"I know the Cotton Company had a class book wherein was listed all cotton by bale number that was purchased and all cotton by bale number that was sold, but I never did look at that book." [Tr. pp. 334-345]

"I never at any time compared any of the monthly statements prepared by the bookkeeper with the books of the Cotton Company to ascertain if they were correct and I never went to the plaintiff bank to check as to the amount of cash on hand. (Italics ours.) I knew in a general way that the books that were kept by the Cotton Company were kept "cotton wise'—that is, that it had a Purchase & Sales book, and Acceptance Account, a Cotton Account, and a bale book, and that they kept these books up." [Tr. pp. 345-346.]

"I did not at any time make any check of the written statements which were prepared by Mr. Norsworthy, with the books of the company. I did receive and examine, however, a statement showing the transactions of the cotton company's business for the

first year, but I do not now recall its contents." [Tr. p. 382].

Mr. Norsworthy, who was bookkeeper for the cotton company during the whole period in question testified as follows:

"Mr. West was occasionally in the office of the cotton company, probably once every ten days and he never did, that I know of, make any audit of the books and if he had made such an audit I think I would have known. West never made any examination of the books in my presence." [Tr. p. 422.]

The testimony of Mr. West further shows that during the second season of the cotton companys' operations—that is, from the fall of 1920 until May of 1921, he considered that he had no direct financial interest in the business and was only interested to see whether or not Sears, to whom West had sold all the stock of the corporation, was likely to make sufficient money to pay West for the stock. On this point West testified [Tr. p. 395] that he made the sale of the corporate stock to Sears on the basis of the ending of the business year, April 30, 1920; and again [Tr. p. 396]; that:

"A. And I wanted to be relieved of any responsibility for the incoming season's business. I wanted to withdraw from my responsibility. And we agreed then—

"Q. No, just what was said. Do you mean by 'agreed' that it was stated?

"A. It was stated that we would transfer the stock back then to the end of the business year, and I re-

marked that 'We can't transfer it farther back than where I appeared in a meeting of the board of directors.' So we then went to Hartke and found that it could be transferred as of May 24. We would have transferred it April 30 if we could, at the end of the business year. And then it was done."

"Q. By Mr. Parke: Well, what, if anything, did you do as treasurer after August, 1920?

"Mr. Cosgrove: Now that is susceptible to the same objection.

"Q. By the Court: What did you do acting with the corporation?

"A. I didn't do anything acting with the corporation after 1920.

"Q. By Mr. Parke: After August, 1920?

"A. No."

The learned trial judge in his opinion [Tr. p. 175] properly summarized the situation as regards the examination of the books by West as follows:

"West testified that his investigation of the books only went so far as to give him information as to the purchase and sales account—that is, how much cotton Sears was buying, how much he was selling, and as to whether he was 'hedging' his business * * *

"Under the representation made by West that he would check the books every month, it became the cotton company's duty not only to report promptly to the bonding company any dereliction of Sears, in the regards specified in the bond, *but upon the occurring of any such dereliction which West would have discovered had he made the inspection of the books and accounts which he agreed to make, the failure to make such inspection and report would exonerate the*

insurer; and it must be concluded that if the bonding company might in any event be held responsible for the overdraft of Sears on his personal account, that the cotton company relieved the insurer because it failed in its duty to properly inspect the accounts and make report."

The foregoing constitutes all of the testimony in relation to the examination of the cotton company's books by West, and it is respectfully submitted that such cursory examination of only a portion of the books of the cotton company and no examination at all of the books reflecting the financial condition of the company, or the manner in which its receipts and disbursements were being handled, is a breach of the warranty above set forth.

The fact which may be urged by defendant in error and as indicated by the trial court in its opinion that a checking or auditing of the books might not have disclosed that Sears was improperly applying moneys realized from the sale of cotton which should have been paid to the bank under the trust receipts, does not relieve the cotton company from its obligation to comply with the warranty—that is, have the books checked and audited in accordance with the express agreement. It is not disputed that during both the years of the cotton company's operations substantially all cotton purchased was handled through the plaintiff bank and trust receipts given for the warehouse receipts, and that in no single instance were the "outbound documents" returned in direct payment or discharge of the trust receipts, but in all cases the pro-

ceeds from the sale of cotton covered by trust receipts was deposited in the general checking account of the cotton company, from which account checks were drawn from time to time in payment and discharge of acceptances and trust receipts, and from this same general checking fund all the operating expenses of the cotton company were paid. A school boy, had he made any check of the books of the cotton company, would have observed these facts. It is not disputed that a complete record of the indebtedness of the cotton company to the bank was kept, and both Mr. Farrar and Mr. Cole, certified public accountants, who testified at the trial, were able by an audit and check of the books to quickly determine that cotton covered by trust receipts held by the plaintiff bank had been sold and the proceeds applied other than in discharge of the trust receipts.

It is respectfully submitted, however, that whether a check or audit might or might not have disclosed any irregularities, the absolute duty rested upon the bonding company to have such check and audit made. The fact that a check or audit is being made regularly in each month often is the controlling influence which prevents a trusted employee from committing irregularities.

The learned counsel for defendant in error urged at the trial in the lower court that under the warranty there was no requirement that an audit or verification of the books and accounts of the cotton company be made, but merely a checking up of the books. It is respectfully submitted that there was not even a

"checking up," and further that the answer made to the question in warranty No. 12 must be read in the light of the questions and when questions and answers are read together they certainly mean more than that a mere cursory inspection or checking up of one particular phase of the companys' transactions—that is, cotton bought and sold, would be made. This is all West says he did or intended to do and that this inspection was very perfunctory during the second year. Question and answer (D) states affirmatively that *inspections and audits* will be made by T. J. West. It is not claimed by defendant in error that any audit was made of the stocks and securities, or that there was any attempt made to verify the securities or funds on hand or in bank. During the period when the alleged loss was sustained no check of any of the cotton company's books was ever made. During all this time West testified that he did not know even where the proceeds from the sale of cotton was being deposited, notwithstanding the fact that full entries of such deposits and of the disposition thereof were fully reflected in the books.

THE LAW.

The Failure of the Cotton Company to Have T. J. West Make a Monthly Examination, Audit and Check of the Books as Agreed Releases the Bonding Company From all Liability.

In a recent case of Maryland Casualty Company v. Bank of England decided by the Circuit Court of Appeals of the Eighth Circuit and reported in 2 Fed.

(2d Edition) 793, the defense was interposed by the Maryland Casualty Company that the insured had failed to have the books examined as expressly provided in the promissory warranties made by the insured. In that case, question No. 11 contained three questions and answers thereto, as follows:

> "In case of applicant handling cash or securities, how often will the same be examined and compared with the books, accounts and vouchers, and by whom? (a) Monthly.
>
> "Will any examination of the applicant's accounts be made outside of the audit of the state or national bank examiners? (b) No."

The trial court found that in effect the questions and answers amounted to nothing more than an agreement that the accounts of the insured would be examined by the state bank examiner and that since under the law the state bank examiner was not required to make monthly examinations, the warranties were not breached by the fact that only a yearly examination was made by the state examiner.

The case was reversed on appeal, the Appellate court holding that the second question and answer did not relieve the insured from having its cash and securities examined and compared with the books, accounts and vouchers each month. In passing upon the question, the Appellate court said:

> "It is true that it is a rule of construction that ambiguities should be resolved against the drawer of an instrument and that this rule has been properly applied to insurance contracts. American

Surety Co. v. Pauly, 170 U. S. 133, 144, 18 S. Ct. 552, 42 L. Ed. 977. However, this does not mean that the contract can be changed or 'refined away' by this mere rule of construction (Guarantee Co. v. Mechanics' Savings Bank & Trust Co., 183 U. S. 402, 419, 22 S. Ct. 124, 46 L. Ed. 253), nor that all other rules of contract construction must stand silent in the presence of this rule. Other rules of construction are that all parts of a contract must be given a reasonable meaning and vitality and that parties are presumed not to insert idle, foolish, meaningless language.

"We think the parties had no difficulty in understanding each other and that, to them, both of the questions and the answers thereto were intended to have the meaning above set forth.

"As the bond expressly provided that it should fail if these monthly comparisons were not made and as they were not made, the bank cannot recover. The difficulty in this, as in some other insurance cases, is that the insured takes the view that all that is necessary to recover on a bond or policy is to pay the premium and suffer a loss. That is rarely the case. The premium is graduated according to the extent of risk as based on experience and reason. The risk of turning a person loose with money without check, word or supervision is one thing, while the risk on the same person under careful, frequent check and supervision is quite another. These promissory obligations of the insured which affect the risk are about the only safeguards the insurer has and cannot be lightly disregarded."

The following cases are also helpful in determining the extent to which the courts require a substantial compliance with a warranty of this character:

United States Fidelity & Guaranty Co. v. Downey, 10 L. R. A. (N. S.) 323,

The syllabus is:

"The requirement of an application as to examination of books is not satisfied by accepting as true the amount the employee has in bank as shown by deposit book * * * without any investigation to ascertain from the bank if the statement was true."

Further continuing the court said:

"The bond provides, among other things, that the Miners' Union should notify defendant immediately upon discovering any fraud or dishonesty on the part of an employee. The statement made in the application, to the effect, that the accounts of the employee should be examined and verified quarterly, was made for the evident purpose of enabling the guarantor to know what means were to be adopted by the employer to discover fraud or defalcation in the event of its occurrence. It is alleged in the complaint that the shortage of Hogue was not discovered until February 16th, more than two months after the quarterly examination of December 10th. For aught that appears in the testimony, much of this shortage may have existed at the time of the at tempted examination of the accounts. This examination was made by two of the trustees according to their own testimony. They made no investigation whatever to ascertain the amount

of money Hogue actually had in the bank, and, in checking up the funds on hand, merely took the balance shown by Hogue's bank book. It needs no argument to show that without such an investigation at the bank there could be no checking up of funds on hand. For anything which the trustees might have known, the cash which they claimed Hogue had on hand might have been drawn from the bank subsequent to the balancing of the bank book, and was not a compliance with the safeguard which the union had agreed to give to the defendant.

"To verify means to prove to be true or correct; to establish the truth of; to confirm. Nothing of this nature was done, or attempted to be done by the trustees, so that there was an absolute breach of the contract made by the union which was the inducement offered defendant for making the bond. The union having failed to do that which it was compelled to do under its agreement, released appellant from all liability under the bond."

Young v. Pacific Surety Co., 137 Cal. 596, the syllabus is:

"Where the applicant for the bond of indemnity represented that the books and accounts of the cashier and bookkeeper could be examined and audited, and all moneys, securities, vouchers, and property on hand would be examined and verified daily, and the applicant, by reason of absence, failed for four days to comply with the terms of the contract, during which time the cashier absconded with his employer's money, such failure discharged the surety from liability upon the bond."

Hunt v. Fidelity & Casualty Co., 99 Fed. 242.

This was a suit upon a policy to indemnify a Fire Insurance Company against loss through embezzlement of an agent. The application for the bond provided that the cash would be compared and verified once a month, and that the statements therein by the terms of the policy "constituted an essential part and formed a basis of the contract." Each month a check was compared and verified with vouchers furnished. During the period of the insurance the company did not at any time compare and verify the cash in the agent's hands, or his bank balance with the accounts kept by him at his office in New York. During the period of the insurance it is found that there was a deficiency in his accounts, and that he had collected and converted money of the company to his own use. Page 244:

> "The court below directed a verdict for the defendant upon the ground that it was established that there had been no monthly examination by the assured of the cash and accounts of its agent, in compliance with the promise of the assured.
>
> "Reading the several statements of the assured together, it is plain that the statement that the cash to be compared and verified monthly with accounts and vouchers meant that the assured would monthly examine the accounts and vouchers of its agent, and compare and verify them with the case in his hands, in order to ascertain the correctness of his accounts. Such an examination would have shown what he had received by way of premiums, what he had disbursed by way

of expenses, what he had transmitted to his principal, and how the balance compared with his moneys on hand. A monthly verification of that character would tend to exercise a salutary check upon the transactions of the agent in dealing with the funds of his employer, and might prevent, as well as reveal, any irregularities or dishonest manipulation on his part. It would to some extent, at least, have been a safeguard to the employer and to the insurer, who was to become responsible for any defalcation of the agent."

Page 245:

"The promissory statement, having been made part of the contract between the parties, by the terms both of the policy and the declaration, was, in effect a *warranty* which the assured was bound to fulfil in substance and according to its meaning. Jeffries v. Insurance Co., 22 Wall 53, 22 L. Ed. 833; Ins. Co. v. France, 91 U. S. 513, 23 L. Ed. 401; Brady v. Association, 9 C. C. A. 252, 60 Fed. 722; Missouri K. & T. Co. v. German National Bank, 23 C. C. A. 65, 77 Fed. 117. It is quite immaterial that the statement is not called a warranty. It is a stipulation embodied in the contract, by the words of the policy, for the performance of future acts, and, as such, is an express warranty. Arn. Ins. (6th Ed.) 599; Ang. Ins. Secs. 140, 141 * * *

"It appeared beyond question upon the trial that its promise to examine its agent's cash monthly had not been fulfiled by the assured. The monthly comparison of the checks sent to it by its agent with the accounts and vouchers sent by him two months previously was not a comparison of the cash in his hands with his re-

ceipts and disbursements, but was merely a comparison of a part of it,—the part which he had transmitted. It did not involve any examination of his accounts in order to ascertain whether his cash on hand corresponded with the premiums received within the last two months. No attempt was made to ascertain this by the assured. What was done was of no value in comparing the cash actually in the agent's hands with the amount which he ought to have on hand at that time. In ruling that the promise of the assured had not been fulfilled, and that the *defendant* was therefore entitled to a verdict, the court below was clearly correct."

Ellzey v. Mass. Bonding & Ins. Co., 142 La. Column 818.

This was a suit upon a fidelity bond guaranteeing the Producers Association against loss in the conduct of its financial affairs by its president. The bond provided that the company would verify the accounts of the president monthly.

On page 820 the court say:

"Before consenting to become surety for Monata, defendant presented to plaintiff association a form of application containing various questions to be answered by it, and the concluding clause of said application contains a stipulation to the effect that the answers are warranted to be true and are conditions precedent to a right of recovery upon the bond applied for, and by the terms of the policy said statement and answers of plaintiff are made part thereof. The answers are to the effect that Monata was to account

monthly to the board of directors, that the books of Monata were to be examined monthly by an auditor or expert accountant, that the funds of the association were to be deposited in the Bank of Hammond and to be withdrawn only by checks signed by Monata and counter-signed by S. B. Ellzey, secretary and treasurer.

"The evidence shows that the bond was given and signed on February 17, 1912, that Monata began his peculations about the 3rd of April, and continued the same until about May 7th, 1912; that the shortage was discovered about the 12th day of May; and that no examination or audit of Monata's accounts had been made prior to that time.

"The question for decision, therefore, is what is the effect of plaintiff association's failure to carry out the promises which, in its application for the indemnity bond upon which it sues, it expressly made and warranted, when it stated therein that the accounts of Monata would be checked monthly by the board of directors, and the accounts of Monata would be audited monthly by an expert accountant? The statement thus made in the application is very material to the contract entered into by the defendant, and has a very important bearing upon the risk thus assumed by it. It can be viewed in no other light than a promissory warranty, and the law is explicit that the non-observance of a promissory warranty vitiates the contract. Hunt v. Fidelity & Gas. Co. of N. Y., 39 C. C. A. 496, 99 Fed. 242; Winkler Brokerage Co. v. Fidelity & Deposit Co. of Maryland, 119 La. 736, 44 South 449.

"Plaintiff realizing that it had failed to carry out the promises which it made in its application

for the indemnity upon which it now sues, advances in argument the equity of its demand; but we are powerless to assist it in evading or charging the provisions of a contract which it voluntarily entered into, and which constitute the law between itself and defendant.

"It is therefore ordered that the judgment appealed from be set aside and reversed, and plaintiff's suit dismissed, at its costs in both courts."

Bank of Cotton Valley v. McInnis, 143 La. Column 436.

This is a suit against the American Bonding Company as surety on a fidelity bond of its cashier, in which case a judgment was rendered against the cashier for the amount of his defalcation. The bond provided "that if the employer, or any of the officers of the employer *became aware* of the employee gambling speculating, etc., the employer shall immediately notify the surety company in writing." It further provided that the books should be balanced monthly. The bond further provided: Columns 439-440-441:

"'It is agreed that the above answers shall be warranties, and form a part and be conditions precedent to the issuance, continuance, or any renewal of, or substitution for the bond that may be issued by the American Bonding Company of Baltimore, in favor of the undersigned, upon the person above named.'

"The foregoing questions and answers have been quoted for the reason that each one in turn has been violated by the plaintiff bank; and, as they, under the agreement, are 'warranties,' and

form parts of and are made conditions precedent to the issuance, continuance or renewal of, or substitution for, the bond, they have the effect of defeating plaintiff's claim for indemnity.

"As before stated, plaintiff, in its petition, alleges that Mc Innis, while acting as cashier of the bank and in the employ of petitioner, did, during the life of said original bond and continuation certificate defraud your petitioner out of over $5,000.00 by fraudulent acts and false entries on the books of the bank. Yet, in answer to the question propounded at the time of the issuance of the continuation certificate, the officers of the plaintiff bank answered that McInnis was not indebted to the bank or its officers. Plaintiff seeks to excuse itself on the score of ignorance. But, it was its duty to know the condition of the books of the bank, and to know whether McInnis was indebted to the bank or not. The cash of the bank was not balanced daily, as the bank agreed should be done by McInnis. On the contrary, it went many days, sometimes as many as nine days, without being balanced. It was further stipulated that the loan committee of the bank would examine and compare the books, accounts and vouchers once a month, *which was not done* * * *

"In addition to the small insurance business which plaintiff, said McInnis, was engaged in with its approval, he was also engaged in the cotton business to the knowledge of the officers of the bank. The cotton business was clearly speculative, and it had been stipulated in the bond 'that if the employer, or any of the officers of the employer, become aware of the employee gambling, speculating, etc., * * * the employer

shall immediately notify the surety in writing'. This the employer did not do.

"The statements made by the bank in its application to the bonding company are very material to the contract entered into by it and the defendants, and have very important bearings upon the risk assumed by the latter. They were declared to be warranties, and the non-observance of those warranties vitiated the contract.

"Plaintiff and defendants agreed that the answers to the questions propounded by plaintiff to defendants should be warranties and form parts of and be conditions precedent to the issuance, continuance or any renewal of or substitution for, the bond that was issued by the American Bonding Company of Baltimore in favor of plaintiff.

"It lies within the power of contracting parties to make any matter material to the contract, although such matter may seem to be of little or no value to either party to the contract. When the parties themselves have seen fit to make certain facts the basis of a contract of fidelity insurance the courts will not assume to correct the understanding of the parties as to the materiality of such facts. When the parties have stipulated that a fact is material, the false representation of the existence or non-existence of any such fact will avoid the contract. Hunt v. Fidelity & Casualty Co., 99 Fed. 242, 39 C. C. A. 496; Willoughby v. Fidelity etc. Co., 16 Okla. 546, 86 Pac. 56, 8 Ann. Cas. 609."

U. S. F. & G. Co. v. Downey, 38 Cal. 414.

This case again came before the Supreme Court of Colorado in 88 Pacific 451, and the court said:

"A guaranty company gave a bond to a fraternal union to secure the faithful discharge of the duties of its treasurer. The bond provided that the union should notify the company immediately upon discovering any fraud or dishonesty on the part of such officer. In its application, the union stated that the treasurer's accounts would be examined and verified every three months by its board of trustees, and that the business of the union should continue to be managed as above set forth, and it stipulated therein that the answers, statements and representations therein made should be considered warranties. A quarterly examination was made in December, at which time it was found that the treasurer should have had $740.00 on hand. He submitted a bank book showing deposits of $440.00, and the balance in cash, but the amount alleged to be in bank was not verified. In February following it was learned that he was short in his accounts. Held, that the union's failure to verify the correctness of the amount of funds in the hands of the treasurer was not a compliance with the safeguard which it had agreed to give the company, and the latter was therefore relieved of liability under the bond."

Pages 418-419:

"For anything which the trustees might have known, the cash which they claimed Hogue had on hand might have been drawn from the bank subsequent to the balancing of the bank book, and therefore, there was not a compliance with the safeguard which the union had agreed to give to the defendant.

"To verify, means to prove to be true and correct, to establish the truth of, to confirm. Nothing of this nature was done or attempted to be done by the trustees, so that there was absolute breach of the contract made by the union, which was the inducement offered the defendant for making the bond. The union having failed to do that which it was compelled to do under its agreement, released appellant from all liability under the bond."

"The verification of an officer's accounts, required by his fidelity bond, is not satisfied by accepting as true the amount which he has in bank as shown by his bank pass book, without taking any steps to ascertain from the bank whether or not it represents the true state of the account."

U. S. F. & G. Co. v. Bank of Batesville, 87 Ark. 348.

The second syllabus is:

"Where, in the application of a policy insuring the fidelity of an employee, the employer represented and warranted that it would check up the employee's accounts three times a month, and failed to do so, such failure avoided the bond."

On pages 359-360 the court says:

"No effort was made to ascertain if the money was actually on hand, nor to ascertain in whose possession it was. The plaintiff bank knew that Smith left money with the various subcontractors or deposited it with the local banks most accessible to them, to be used by them in discounting and buying up time checks. No inquiry was ever made, nor report given of the amounts in the

hands of the various subcontractors. Had this been done at stated intervals, the bank could have known in whose hands its money really was, and any mistake made by any of the numerous persons handling the money could have been properly corrected, and no shortage would probably have resulted.

"The questions asked and the answers given in the application for the bond show that it was in the contemplation of the parties to adopt some system whereby the bank should know at frequent intervals the exact state of the accounts between it and the employee, who was the principal in the bond. Evidently this result could not be accomplished, unless the checking up meant not only the examination of the record of the amounts furnished Smith and the time checks remitted by him, but where the money was put out in the hands of numerous persons, as was done in this case, it was also required that the part of the duty of plaintiff bank in checking up the accounts of Smith and requiring of him an account of his handling of the funds once a month would be not only to ascertain the balance that should be on hand but to find out in whose hands it actually was at the time.

"Reversed and dismissed."

See also:

Garstires v. American Bonding Co., 116 Fed. 449.

VII.

The Cotton Company Cannot Deny Knowledge of the Performance by Sears of the Acts Done by Him as Secretary and Which It Is Now Claimed Were Dishonest, for the Reason That the Acts Done by Sears Were, as Expressly Plead by Plaintiff, Within the Scope of His Duties as Secretary and Were for the Exclusive Benefit of the Cotton Company in the Prosecution of the Business for Which It Was Incorporated. It Is Not Claimed That Sears Sought to Gain Any Personal Advantage or Benefit to Himself or to Any Other Person Than the Cotton Company.

The Failure of the Cotton Company, Having Knowledge of the Acts of Sears Now Complained of, to Notify the Bonding Company Thereof Within the Time Provided in the Bond, Prevents Any Right of Recovery Thereon and It Estops the Cotton Company From Maintaining Any Action Predicated Upon the Alleged Fraudulent Acts. In View of This Knowledge on the Part of the Cotton Company It Was Error for the Trial Court to Find That Any Fraud or Deceit Was Practised by Sears Upon the Cotton Company.

Assignments of Error 18, 21, 24 and 4 to 17 Inclusive.

The foregoing proposition is advanced not solely with the view of predicating thereon the defense of

failure on the part of the cotton company to give notice to the bonding company within the time provided in the bond, but also for the purpose of showing that what Sears did was a matter of fact and of law known to and approved of by the cotton company and that the cotton company with this knowledge permitted Sears to continue over a period of a year and a half to operate the company's business in the way and manner now sought to be charged as fraud.

Facts.

Plaintiff's case is predicated upon the theory that no one save and except Sears took any active part in directing the affairs of the cotton company. Two of the directors, Conduit and Hartke, testified that they took no part whatsoever except to attend directors' meetings, and McDevitt, president, testified that he knew nothing whatsoever of the affairs of the company. West took no part except occasionally to visit the office and examine the cotton record book.

As in this brief before set forth, all matters in relation to the financing of the cotton purchased was left to Sears, but the plan of securing a line of credit from the bank and having the bank pay for cotton, etc., was as outlined in the letter of September 8, 1919, known to and approved of by Mr. McDevitt and Mr. West, and that such plan was the usual and customary way of handling the cotton brokerage business. Furthermore, both McDevitt and West testified [Tr. p. 274 and p. 340] that they knew that Sears was conducting the business in that manner, and that they approved of

that method of doing business. The only thing they objected to was the fact that the money received from the sale of cotton covered by trust receipts was not all applied in discharge of the trust receipts.

It is expressly admitted, however, that the acts of Sears now complained of as fraudulent, were done during the entire first year of the company's operations and at all times during the second year, that is, he always deposited the proceeds for the sale of cotton covered by trust receipts in the general checking account out of which acceptances and general expenses of the cotton company were paid. The books and records of the cotton company without dispute clearly reflect that the business was handled in this manner. An inspection of the cotton company's bank book or check book would have disclosed this fact. At no time does it appear that any inquiry was ever made of Sears by any of the directors as to how he was handling the money received from the sale of the cotton covered by trust receipts, and consequently there were no misrepresentations made to them by Sears in that regard. It is idle to suggest that Sears was moved by some ulterior motive in handling the finances of the cotton company during the second year, since they were handled in identically the same manner as during the first year during which, except for bad loans made with the approval of the other officers of the cotton company, a very substantial profit was made from the buying and selling of cotton.

It must be concluded that if West made any examination of the cotton company's books, they met with

his approval, for we find no record of any complaint being made. He, West, testified [Tr. p. 345] that they appeared to be kept properly, and Mr. Norsworthy testified [Tr. p. 403] that they were kept in all respects similar to the books kept by McFadden & Company, cotton brokers, and were full and complete. Mr. Farrar, certified public accountant, testified [Tr. p. 442] that the books were full and complete and after Sears' death balanced within 10¢. There was a dispute between the auditor who testified on behalf of the plaintiff in error and the auditor who testified on behalf of the defendant in error as to whether or not a cotton trust account covering the liability of the cotton company to the bank for warehouse receipts entrusted to it, should have been set up in the books. The auditor for the defendant in error believes such an account should have been set up, while Mr. Farrar, auditor for the plaintiff in error, and Mr. Norsworthy, the bookeeper, both testified that in their opinion, such an account was not necessary to reflect the true financial condition of the cotton company, and Mr. Norsworthy testified [Tr. p. 412] that he had been the bookkeeper for, and had audited a great many sets of cotton brokerage books, and had never seen such an account set up. If such an account was necessary such fact would have been apparent to Mr. West had he examined the books, but no complaint was made.

It is respectfully submitted that the evidence does not warrant the finding of the trial court that Sears wilfully falsified the books and records of the cotton company.

In brief, the record discloses that everybody concerned—that is, the officers of the bank and the officers of the cotton company, knew and approved of everything that was done by Sears on behalf of the cotton company except the manner in which the proceeds for the sale of cotton were disbursed. The books and records of the cotton company and the large number of transactions aggregating more than a million dollars, carried on between the cotton company and the bank, clearly reflected and brought home to each corporation full knowledge of the manner in which the funds of the cotton company, realized from the sale of cotton, were being disbursed,—to-wit, that such proceeds from cotton covered by trust receipts was being commingled with other funds in the general checking account and disbursed for all purposes of the cotton company, including the payment of acceptances and outstanding trust receipts and general operating expenses. As to all transactions had with the bank by Sears acting as secretary for the cotton company, both the cotton company and the bank are bound to know the facts when those transactions were in the regular course of the cotton company's business and of the bank's business and for their use and benefit and transacted by their corporate officers within the scope of their duties, and not for the personal gain or advantage of the officers transacting the business.

THE LAW.

Since the Cotton Company, Insured, Became a Corporation Sole—To-wit, J. B. Sears, on December 1st, 1920, It Must Be Charged With Full Knowledge of All of the Acts Thereafter Performed by J. B. Sears. It Was the Duty, Therefore, of the Cotton Company, Having Such Knowledge, to Promptly Report to the Bonding Company the Acts Upon Which Loss Is Now Predicated. No Report Was Made Until July, 1921, or a Period Far Beyond That Expressly Provided in the Bond. Such Failure to Notify the Bonding Company Released the Bonding Company From Liability.

Furthermore, It Cannot Be Said That the Cotton Company Did Not at All Times Prior to the Date When It Became a Corporation Sole—To-wit, J. B. Sears, Have Knowledge of the Acts Being Performed by J. B. Sears and Which It Is Now Claimed Were Wrongful.

In the case of Davies & Co. v. Porter, 248 Fed. 397 (Circuit Court of Appeals, Eighth Circuit), suit was brought by Porter, the plaintiff below, as receiver of the elevator company, to recover money paid to Davies, the defendant below, by one A. J. Norby, which money belonged to the elevator company, as was well known to Davies & Co., the defendant, and was used for alleged wagering transactions. The question was: "Were Norby's transactions with the defendant for

himself or (as general manager of the elevator company) *for the elevator company and its sole benefit?"*

The undisputed evidence shows that the elevator company was a South Dakota corporation; that the directors were Mr. Porter, president; Mr. McNulty, vice-president; and *Mr. Norby, secretary and general manager.* (THIS WAS EXACTLY SEARS' POSITION IN THE CASE AT BAR.)

The company transacted its business through Norby, who had sole charge of it in Minneapolis. The management of the company's business in Minneapolis was left entirely in charge of Norby. The other directors but rarely visited that office and never examined its books. The checks were given in all transactions, most of them drawn by Norby, as secretary, and some by Miss Baker, the bookkeeper, at the request of Norby. *(Miss Baker occupied the position of Norsworthy in the case at bar, drawing checks at the request of Sears.)*

On pages 400-401. the court say:

> "During the time these transactions took place, the defendant paid to Norby at different times, as profits, sums amounting to $19,444.94, all of which was paid by checks payable to Norby, and by him deposited to the credit of the elevator company and credited on its books. Had the directors, or either of them, examined the books of the company, they would have learned of these tranactions and that they were for the sole benefit of the company. *From a careful reading of the testimony it is impossible to escape the conclusion*

that it establishes conclusively that Norby's transactions were for the sole use and benefit of the company, and that were carried on in his name, and for the only reason that the membership in the Chamber of Commerce was in his name. The neglect of the other directors, who were the sole stockholders, besides Norby and his wife, to examine the books of the corporation for years, which would have shown these transactions, and failing to make any effort whatever to ascertain how the business of the company was being conducted by Norby, was not only a breach of their duties as directors, but also, as by the exercise of any diligence whatever, they could have ascertained the facts, they must be held to have knowledge of them. Gold Mining Co. v. National Bank, 96 U. S. 640, 24 L. Ed. 648; Rolling Mill v. St. Louis etc. Co., 120 U. S. 256, 7 Sup. Ct. 542, 30 L. Ed. 639; Pittsburg etc. Co. v. Keokuk, 131 U. S. 371, 9 Sup. Ct. 770, 33 L. Ed. 157. In Brown's Valley State Bank v. Porter, 232 Fed. 434, 146 C. C. A. 428, an action arising out of similar transactions of Norby as general manager of the elevator company, in which the evidence was very much like that in this case, we held that his acts were those of the corporation."

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"The court erred in refusing to direct a verdict in favor of the defendant, and the cause is reversed and remanded, with directions to grant a new trial."

McCaskill v. U. S., 216 U. S. 504. In that case suit was brought by the United States to cancel a patent to land to W. J. Ward and a deed to McCaskill

Company upon the ground that his proof was fraudulent and untrue. The land was conveyed by Ward to McCaskill & Company, the copartnership. They afterwards incorporated the McCaskill Company and deeded the land to said company. The answer alleged that the McCaskill Company was a *bona fide* purchaser.

On page 514 the court say:

> "Does applicant occupy the position of the innocent purchaser, and is the Government precluded from receiving the relief prayed for in the bill, because of such fact? The answer to the question depends upon a proposition of law, and whether J. J. McCaskill had knowledge of the fraudulent acts of Ward. This knowledge was, in effect, found, by both the lower courts, and, giving to their finding the strength that should be accorded to it, we pass to the consideration of the proposition of law that the knowledge of J. J. McCaskill, though president of the McCaskill Company, cannot be imputed to it, because, as appellant's argument is, while the knowledge of an agent is the knowledge of the principal, an 'exception to the rule is that if the agent is acting in a matter in which he has a personal interest, or in communication with which he is interested with a third person, the presumption is that he will not communicate the facts in controversy,' and it is urged that 'the rule should be rigidly applied in cases of fraud or torts.' For these propositions, appellant cites Clark v. Metropolitan Bank, 3 Duer (N. Y.) 241; Frenkel v. Hudson, 82 Ala. 162; Allen v. South. P. R. R. Co., 150 Mass. 200;

Innerarity v. Mer. Nat. Bk., 139 Mass. 332; Atlantic Nat. Bk. v. Harris, 118 Mass. 147; Loring v. Brodie, 134 Mass. 453; Hightstown v. Christopher, 40 N. J. L. 435.

"Undoubtedly a corporation is, in law, a person or entity entirely distinct from its stockholders and officers. It may have interest distinct from theirs. Their interests, it may be conceived, may be adverse to its interest, and hence has arisen against the presumption that their knowledge is its knowledge, the counter presumption that in transactions with it when their interest is adverse and knowledge will not be attributed to it. But while this presumption should be enforced to protect the corporation, it should not be carried so far as to enable the corporation to become a *means of fraud or a means to evade its responsibilities.* A growing tendency is therefore exhibited in the courts to look beyond the corporate form to the purpose of it and to the officers who are identified with that purpose. Illustrations are given of this in Cook on Corporations, sections 663, 664 & 727. The principle was enforced in this court in Simmons Creek Coal v. Doran, 142 U. S. 417. In that case a corporation claimed title to land through a deed of its corporators, one of whom became its president. Of the effect of this, the court said: 'Associated together to carry forward a common enterprise, the knowledge or actual notice of all these corporators, and the president was the knowledge or notice of the company, and if constructive notice bound them, it bound the company.'"

In the case of Phillips v. U. S. F. & G. Co., 193 New York Supplement, 468, the plaintiff was liquidator

of the New York National Insurance Company and sought recovery upon a depository bond issued by the defendant. It appears that James J. Boland was president of the James J. Boland Company, which, in fact, was the owner of and controlled the New York National Insurance Company. It was he who applied to the defendant for the depository bond. At the time the application was made, he knew that the risk, to-wit, the North Penn Bank, was insolvent. The bond guaranteed the re-payment by the bank of all moneys deposited with it. The court held that the knowledge of Boland while acting within the scope of his duties and for the benefit of the New York National Insurance Company (insured) was the knowledge of the insured; that since the insured had knowledge of facts which it concealed from the surety company there was no liability. On page 482 the court said.

> "James J. Boland, the president of James J. Boland Company, which, as the general agent of the N. Y. National and The Seneca Fire Insurance Companies, had in charge the procurement of depository bonds for these companies, himself directed the procurement of the bond now in suit, and the bond of the Maryland Casualty Company issued on May 26th. James J. Boland, as before related, was also the president of the N. Y. National and The Seneca Fire Insurance Companies. The N. Y. National and The Seneca Fire Insurance Companies paid no premiums, made no contracts and procured no bonds unless James J. Boland, their president and the president of their general agent, was present when the bonds were

obtained; in effect, the very corporations which he represented. There is not here presented, therefore, the question as to when the knowledge of an agent is attributable to the principal in reference to transactions performed on behalf of the principal by an agent other than the one having knowledge. These corporations acted to obtain bonds only if the acts of James J. Boland were corporate acts. *If James J. Boland was the corporation* which obtained the bonds, then the *knowledge possessed by him when he obtained them was corporate knowledge.* The authorities are clear upon this point. Holden v. N. Y. & Erie Bank, 72 N. Y. 286; Taylor v. Commercial Bank, 174 N. Y. 181, 66 N. E. 726, 62 L. R. A. 783, 95 Am. St. Rep. 564; Rocky River Development Co. v. German American Brewing Co., 193 App. Div. 197, 184 N. Y. Supp. 155."

Page 483:

"In our case the James J. Boland Company and its directors were not acting for themselves in procuring these bonds, but for their insurance companies, which, under all the authorities are therefore chargeable with the knowledge possessed by them."

The Appellate Court reversed the judgment against the Surety Company.

Fairchild v. McMahon, 139 N. Y. 290. The second syllabus is:

"All persons who seek for or in the name of the owner in bringing about the transaction must be deemed his agents, where he accepts the fruits

of their efforts, and all the methods employed by them are imputable to him; he may not even, though innocent, receive and recover upon a security given on the sale and at the same time disclaim responsibility for the fraud by means of which the purchaser was induced to deliver it."

Blood v. La Serena Land & Water Co., 134 Cal. 361. On page 370, the court say:

"Whether all the shareholders knew of the commission paid Blood, Jr., is immaterial. If the directors had knowledge at the time the mortgage was authorized by them, or if the president and secretary of the corporation had such knowledge when they executed the mortgage, the corporation is chargeable with the knowledge. The rule of law seems to be, that notice to the individual shareholders is not binding upon the corporation as a collective body; but *notice to its corporate agents, who have authority to represent the whole company,* is notice to the corporation. (1 Morawetz on Private Corporations, Secs. 540b, 540c. See cases collected in note to Bank of *Pittsburgh v. Whitehead,* 10 Watts, 397, in 36 Am. Dec. 186, 188-200.)"

McKenney v. Ellsworth. 165 Cal. 326. The first syllabus is:

"The general rule, that where an agent of a corporation is dealing with the corporation in a transaction in his own behalf, it will not be presumed that he will communicate to his principal facts affecting the transaction, is subject to the exception that if the agent is in fact acting for his principal in the transaction, even though he

> may have an opposing personal interest, it is his duty, notwithstanding his interest, to communicate to his principal any facts in his possession, material to the transaction, and the law will therefore presume, in favor of third persons, that he made such communication."

The position of defendant that the insured cannot recover because it knew of and permitted the continuance of alleged wrongful acts by its managing agent performed in the conduct of its business and for its benefit, is merely a corollary to the other principal point urged by the defendant that the Cotton Company cannot recover for the acts of Sears done within the scope of his duties as it managing agent and for its exclusive benefit and where it, the Cotton Company, received all the benefits and therefore sustained no loss.

Upon the whole case it is very earnestly submitted that in the interests of justice to this plaintiff in error the judgment should be reversed.

Dated, Los Angeles, California, September 15, 1925.

Respectfully submitted,

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